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BOOK REVIEWS

VOLUME 18 NUMBER 1 • PUBLISHED BY THE CATO INSTITUTE

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VOLUME 18 NUMBER 1 • PUBLISHED BY THE CATO INSTITUTE • SPRING/SUMMER 1998

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The CATO JOURNAL is indexed and abstracted in the *Journal of Economic Literature, Current Contents/Social and Behavioral Sciences, Social Sciences Citation Index, America: History and Life, Historical Abstracts, International Political Science Abstracts*, and the **ABI/INFORM** data base. The CATO JOURNAL is available on microfilm from University Microfilms International, Ann Arbor, MI 48106.

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B. R. Shenoy: Stature and Impact

Peter Bauer

B. R. Shenoy was a hero and a saint. He was a hero in the sense in which Thomas Sowell used the term when in a review article he referred to heroic figures who publicly resisted fashionable fads and fancies, however influentially canvassed and widely accepted. He was a saint in that, outwardly at any rate, he remained unmoved, even serene, in the face of neglect, disparagement, even abuse. It is an honor to lecture in memory of such a man. For me it is also an emotional experience. I knew Shenoy personally, and felt great affection and respect for him. I had several extended conversations with him in the late 1950s when he was particularly embattled.

In this lecture I shall quote at length not from Shenoy but from publications reflecting the received opinion, amounting to an orthodoxy, in the 1950s and 1960s both in India and in mainstream development economics in the West. Unless I quote from this literature I cannot convey the difficulties and obstacles Shenoy had to face. And unless I quote at considerable length and from several sources some may think that the passages are out of context or are unrepresentative.

Comprehensive Economic Planning: Shenoy's Dissent

I had never heard of Shenoy until I read the literature surrounding the Indian Second Five Year Plan launched in 1956. I first encountered his name as that of the author of his one man Note of Dissent (Shenoy 1955), appended to the Majority Report of the government advisory panel of economists on the draft of the Second Five Year Plan. The

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government then had a panel of some 20 economists who in April 1955 submitted to the government the draft for an ambitious development plan. This draft in turn drew heavily on a draft plan entitled Draft Plan Frame by Professor P.C. Mahalanobis, Nehru's personal economic adviser. The Majority Report and Mahalanobis's Draft Plan Frame formed the basis of the Second Five Year Plan, the text of which was published by the Government Planning Commission in 1956.

These various documents all took for granted that comprehensive central planning was indispensable for economic progress. They envisaged large-scale money creation for the financing of the highly ambitious Second Five Year Plan, maintenance and expansion of a wide range of economic controls, and extensive nationalization. In his Note of Dissent, Shenoy rejected the general spirit of the Majority Report as endangering personal freedom and a democratic political system. He also disagreed with several major proposals, including the scale of money creation, the maintenance and extension of state economic controls, and the scope of nationalization. He argued specifically that money creation on the scale envisaged by the Majority Report and under the Second Five Year Plan would result in inflation or a balance of payments crisis or both—a prediction that was fulfilled barely a year after the inception of the plan. Both the spirit of the Majority Report and the major proposals reflected the opinions of Nehru, who was then at the peak of his power in India and of his prestige there and in the West. In these conditions, Shenoy's Note of Dissent represented conspicuous moral courage. Moreover, Mahalanobis's Draft Plan Frame and the Second Five Year Plan very largely reflected the then dominant opinion of development economics in the West. Thus, Shenoy's Note of Dissent went counter to the opinions and wishes of Nehru and his personal adviser, and also of the position of the Indian Planning Commission. It also went counter to the then current orthodoxy in the West. Many prominent representatives of that orthodoxy regularly visited India in the 1950s and 1960s. The visitors included Gunnar Myrdal, Joan Robinson, Nicholas Kaldor, Thomas Balogh, Ian Little, Oscar Lange, Paul Streeten, and others. Most of these representatives of the prevailing orthodoxy endorsed the Second Five Year Plan in public pronouncements in India and in prestigious and influential publications in the West, such as the *Economic Journal* or the *Review* of the British National Institute for Economic Research.

The great majority of the representatives of the official national and international aid agencies were committed supporters of the orthodoxy, as were the representatives in India of the Ford Foundation, then the principal source of unofficial aid, whose representatives worked closely with the Planning Commission. Thus, Shenoy's position

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also went counter to the opinions of people who very largely determined the allocation and disbursement of Western aid. Here are two examples of the position of these representatives.

On my first visit to India in 1958, I called on a senior officer of the economic section of the British High Commission. I asked him whether he or his colleagues were in any sort of contact with Shenoy. He said that people there were too busy to have time for acknowledged madmen. It also transpired that he was unfamiliar with the writings or even existence of British or American dissenters from the prevailing orthodoxy. I may add that at about the same time I visited the Delhi School of Economics and the National Council of Applied Economic Research. There also I found considerable and often not well founded disagreement with Shenoy's views, but nothing like the disdain exhibited by this arrogant and ignorant mandarin at the High Commission.

My second example is from an American source. In 1962, John P. Lewis, a full professor of economics at Princeton University and director of the Indian operation of the U. S. Agency for International Development (the official U. S. aid agency), published a substantial volume entitled *Quiet Crisis in India*. Here is a passage from that book:

> It has been decided in India that it is the duty of government—and it cannot be delegated—to create and maintain that "growth perspective" which . . . is the one *sine qua non* for successful economic development.
>
> Outside supporters of the Indian development program who refuse to accept this proposition well-nigh disqualify themselves from the outset [Lewis 1962: 28].

Although this passage is convoluted, the central thrust is clear. Those who dispute the necessity of government control of the composition and direction of economic activity are not qualified to participate in the shaping of economic policy. Thus, according to the director of the most important aid agency then operating in India, Shenoy's position disqualified him from a say in policy. I do not know how much comfort he drew from the fact that he shared this disqualification with Milton Friedman, George Stigler, Gottfried Haberler, Jacob Viner, and others.

Lewis's opinion was not eccentric. Indeed, it largely reflected the received opinion of the 1950s and 1960s. Gunnar Myrdal expressed substantially the same opinion in his much publicized Cairo lectures:

> The alternative to making the heroic attempt is continued acquiescence in economic and cultural stagnation or regression which is politically impossible in the world of today; and this is, of course, the explanation why grand scale national planning is at present the goal in underdeveloped countries all over the globe and why this

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> policy line is unanimously endorsed by governments and experts in the advanced countries [Myrdal 1956b: 65].

Thus, according to Myrdal, experts were unanimous in the 1950s that comprehensive central planning was indispensable for the economic advance of poor countries. It followed that those who like Shenoy disputed this view could not be experts, whatever their formal qualifications, technical competence, or knowledge of the institutional setting.

I trust that I have conveyed something of Shenoy's moral courage in dissenting from the Second Five Year Plan and the orthodoxy surrounding it. But dissent from the received opinion is by itself of no merit unless it is intellectually well founded. Shenoy amply met this requirement. His competence is not in dispute. The tools of trade of economists acting as advisers on policy are microeconomics, macroeconomics (or applied monetary economics and public finance), and knowledge of institutions and magnitudes. Shenoy qualified under all these headings. I commend his Note of Dissent and his book *Problems of Indian Economic Development* (Shenoy 1958) as highly informative introductions to applied monetary economics and to political economy. These publications are not easily accessible, but the effort is worthwhile.

Shenoy's Note of Dissent does not readily lend itself to brief summary or quotation, chiefly because much of it refers to contemporary statistical evidence in support of his position, or to the Majority Report and to documents underlying it. However, the following passages from the Note of Dissent (Shenoy 1955: 25, 30) make clear his general position:

> The size of the Plan Frame has been unduly inflated as a result, on the one hand, of an over-optimistic growth in national income, which it aims at, and, on the other, of an unduly high average rate of saving as applied to this assumed growth in income. A much lower figure would result if both these rates were more realistic projections of Indian experience of the recent past. Though a certain measure of accelerated progress may result as incomes grow and savings increase, a steep upward movement from a background in which the mass of the people live on the margin of subsistence may not be possible except in a totalitarian regime.
>
> . . .
>
> I agree with my colleagues that the scarcity of administrative and specialized personnel, and the necessity of conserving savings for the Plan are factors against extension of nationalization. But they have no objection for such extension on principle. I would oppose general extension of nationalization on principle. Nationalization

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should be ordinarily limited to public utility concerns and to concerns involving national security. Otherwise state intervention should be concerned with the prevention of monopolies or quasi-monopolies. Efficient management of business and industrial concerns in a competitive market economy is a highly specialized function and demands qualities which a civil servant is not required to, and in the ordinary course of his training may not, acquire. This function is best left to private entrepreneurs, in the prevailing socio-economic order which is dominated by the market economy and the pricing system.

. . .

I do not feel convinced of the economic importance of continuing the remnants of controls. Decontrols have proved a noteworthy success. Controls and physical allocations are not a necessary adjunct to planning. The distribution of productive resources, including the ratios in which they are used, are subject to variation and depend upon diverse technological, economic and price considerations. It is quite impossible to take into account these complex and changing considerations and arrange anything like a satisfactory allocation of resources. There are great advantages in allowing freedom to the economy, and to the price system in the use and distribution of the needs of production. I am unable to agree with my colleagues that a case exists for continuing what controls now remain. Steps should be taken to remove controls as early as may be possible. Controls and allocations are an essential characteristic of communist planning. They do not very well fit in under planning in a free enterprise market economy.

The Mid-1950s: High Water Mark of Price-less and Cost-less Economics

In contrast to Shenoy's assured command of basic price theory' and basic monetary economics, influential publication in India and the West of the orthodoxy reflects notable, even startling, neglect both of the basic tenets of economics and of simple empirical evidence.

The mid-1950s—that is, the period of the preparation and launching of the Second Five Year Plan—were the high water mark of price-less and cost-less economics (i.e., disregard of price in discussion of supply and demand, or more precisely, in quantities demanded or supplied). It was in the 1950s that prominent academic economists discussed the so-called dollar problem as a persistent and inescapable shortage of dollars, without mentioning the rate of exchange (i.e., the price of a scarce commodity), or for that matter interest rates either. From the dollar problem, this practice spread to the payment difficulties of less developed countries (LDCs). Exponents of the orthodoxy

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regarded these difficulties as inseparable concomitants of the economic progress of LDCs and especially of government policies designed to permit it. In reality, they were the consequences of inflationary policies pursued under conditions of fixed exchange rates, as was recognized by Shenoy. Gunnar Myrdal, perhaps the most prominent and influential Western guru in India, went as far as writing that "there must be something wrong with an underdeveloped country that does not have foreign exchange difficulties" (Myrdal 1956a: 270).

This totally and demonstrably unfounded opinion suited the purposes of the proponents of ambitious plans financed in part by large-scale money creation.

India's Second Five Year Plan and the World Bank Report

Let me now present two specific and detailed pronouncements of the orthodoxy of the mid-1950s. First, a central passage from the Indian Second Five Year Plan:

> The expansion of the iron and steel industry has obviously been the highest priority since, more than any other industrial product, the levels of production in these materials determine the tempo of progress of the economy as a whole. . . . Heavy engineering industries are a natural corollary of iron and steel works. . . . In this context the creation of basic facilities such as the establishment of heavy foundries, forges and structural shops is absolutely necessary. It is, therefore, proposed that the establishment of these facilities, which constitute an essential and primary phase of development for the manufacture of heavy industrial machinery in the country, should be undertaken at an early date. These developments have a priority second only to that of expansion of the steel industry [Government of India Planning Commission 1956: 394].

These remarks reflect price-less economics; neither price nor cost nor demand is mentioned.

My second example comes from a World Bank report. In 1955, the World Bank published a long report of its mission to Nigeria, which it considered as a guide to policy and as a model for this kind of document. The principal architect of the report was John H. Adler, who had taught at Yale, and who subsequently became the director of the World Bank Economic Development Institute, a prestigious organization for the training of development economists.

Throughout the report the influence of prices on quantities demanded, supplied, or produced is neglected. Demand and supply are treated as physical quantities affected by various factors, but not by price:

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> Expansion [of agriculture] in the immediate future and over the long term will depend upon the degree to which Nigeria can succeed in overcoming or minimizing the effect of such limiting factors as soil deficiencies, inadequacy of water supply in certain areas, low yielding plant varieties, prevalence of plant and livestock diseases, and primitive cultivation methods [World Bank 1955: 371].

Thus, price is not listed among the factors influencing production or the establishment of capacity.

In this case the neglect of price was especially inappropriate. The report was intended as a guide to policy. The producer prices of the principal crops were prescribed by state buying monopolies. And because of large distances and heavy transport costs, the wide extensive margin of cultivation between cash crops and subsistence production, and the ability of producers to shift between activities and crops, the supply of farm products and extension of capacity necessarily depended upon price. Production was possible only with a positive return, and the area in which it was positive depended upon price. Neglect of price necessarily vitiated proposals for an effective fiscal policy.

The Indian Second Five Year Plan and the World Bank report on Nigeria were perhaps the two most important official documents influencing policy in LDCs in the 1950s. They show how price-less economics had engulfed development economics in the 1950s. This development much enhanced the difficulties of Shenoy's stance as he was a market-oriented economist with an assured command of applied basic price theory.

The Danger of External Economic Advice

I said earlier that I had never heard of Shenoy before reading the literature of the Second Five Year Plan. Yet I had heard of several other members of the Government's Advisory Panel, notably D. R. Gadgil, B. N. Ganguli, K. N. Raj, and V. K. R. V. Rao. This reflected the much closer international contacts between socialists or dirigistes on one hand and market-oriented economists on the other hand, a situation to which F. A. Hayek drew attention many years ago. The overwhelming preponderance of supporters of the Second Five Year Plan among foreign visitors to India, including consultants to the government, also reflected this phenomenon, which exacerbated the difficulties of Shenoy in securing acceptance for his views.

There is an important practical lesson to be learned from this experience. Why should the Indian Government or its off-shoots and agencies rely on external economic advice? The tools of trade of an adviser on economic policy are microeconomic theory, macroeco-

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nomic theory (primarily applied monetary economics and public finance), and a knowledge of institutions and magnitudes. There is in India ample indigenous talent in analytical and applied economics. In recent years Indians have occupied some of the most prestigious university chairs in economics at Oxford, Cambridge, the London School of Economics, Harvard, Yale, and the University of California. And, of course, Indians are likely to have a far better knowledge of institutions and magnitudes than have foreigners. If an Indian Government uses external advisers, it should recognize that the advisers are likely to be people whose advice will be in the direction of the maintenance or expansion of the role of the institutions sponsoring them. The government may wish for political reasons to rely on such external advisers, especially if it thinks that by doing so it is more likely to secure external financial support. But the government should be aware of the substantive direction of the advice, which may often differ from the lip service paid by the advisers to the market and to traditional institutions.

Shenoy's Influence

Shenoy has had no influence on Indian economic policy. The original Second Five Year Plan and its various subsequent revisions and sequels reflected the play of political forces and the recurrent balance of payment crises. I believe however that he had considerable impact on the conduct and thinking of Indian economists younger than himself.

This opinion is necessarily conjectural. People's views on economic issues are affected by a multitude of different factors operating with differing and varying time lags. One is prone to overstate the influence of those economists whose views one favors. And economists are apt to make unwarranted claims for the profession. In an often quoted passage Keynes (1936: 383) wrote, "The ideas of economists and political philosophers both when they are right, and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else." If this claim were valid, the world would have been on free trade for decades or centuries, as the great majority of economists have been free traders since Adam Smith.

I can however say with some confidence that Shenoy's conduct and influence have had considerable impact. In the course of my visits to India between 1958 and 1982, a number of economists, including M. P Bhatt, told me that they had been influenced by Shenoy in that they revised their opinions or have become more confident in their position through reading his work.

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There is certainly one economist of whom I can say with absolute confidence that he was influenced by Shenoy. This is myself. He has influenced both my conduct and my opinions. And as it appears from my correspondence that I have influenced some younger people, often in distant countries, Shenoy's impact has extended beyond myself.

The contrast between Shenoy's lack of influence on policy and his impact on other economists is an example of a widely prevalent situation. The political unacceptability or unpopularity of an opinion does not mean that its proponent is less influential than are those whose views are more readily accepted. These latter are sometimes known as realists. There is often a high correlation between the advice tendered by economists and the policy adopted without this indicating that the advisers exercise influence in any meaningful sense. They may only advise policymakers to do what the latter intend to do in any case. Indeed, they may have been selected as advisers because the policymakers anticipated that they would tender the kind of advice which makes it easier for the policymakers to carry out policies and measures which they had planned. I think this was the situation in India at the time of the Second Five Year Plan. The signatories of the Majority Report appeared to be influential since the plan accorded with their views. In reality, they simply endorsed what the government of the day wished to do in any case. So they had little influence either on thought or on policy. In contrast Shenoy's conduct and views influenced a number of people in India and beyond.

Conclusion

It is evident from what I have said that Shenoy united moral courage, intellectual integrity, and technical competence to an exceptional degree. The few people who possess this combination of attributes are of great value, both in public life and in academic study. They are particularly valuable in the study of society, where they are especially rare. May the succession of Shenoy and of his like never fail, East or West.

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The Côte d'Ivoire's Troubled Economy: Why World Bank Intervention Failed

Pascal Wick and Jane S. Shaw

After World War II, Côte d'Ivoire was one of independent Africa's stellar success stories. But in 1976 the country entered an economic slump from which it has never recovered. In 1990 the World Bank finally stopped lending money to Côte d'Ivoire out of frustration at the failure of the government to institute reforms designed to put it back on the road to prosperity. This paper discusses the factors that changed Côte d'Ivoire and addresses the question of why the World Bank, which was Côte d'Ivoire's biggest creditor from 1981 to 1990, failed to correct the nation's problems but, instead, continued to provide loans.

Evolution of the Côte d'Ivoire Society

For 35 years, from the end of World War II to the middle of the 1970s, the economy of Côte d'Ivoire grew rapidly at 8 percent per year. The weakening of the French colonial power and the termination of forced labor in 1946 helped to free the economy. In addition, both the colonial government and the post-colonial government under Felix Houphouët-Boigny took steps to establish a legal system and an institutional framework that fostered a competitive private economy composed of many entrepreneurs.

Gradually, however, the new government began to expand its power over the economy. It took an increasingly active role in the allocation of resources and the redistribution of wealth. In 1970, the government implemented a five-year national plan that affirmed the government's desire to become more actively involved in the allocation of resources.

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The central government began to invest in prestigious but inefficient projects such as the creation of a new capital city and large hydroelectric plants. These projects were financed largely by annual World Bank loans, which did not require that the projects make a financial return. Rather, investment in these projects assured the central government of a steady flow of capital and the employment of a loyal cadre of followers. It is widely known that the ruling class of Côte d'Ivoire withdrew, both legally and illegally, a significant percent of the foreign capital that financed economic development (Ayittey 1992: 240–3).

Yet the foreign bank loans continued. Côte d'Ivoire's public long-term debt was $4.7 billion ($U.S.) in 1980, or 40 percent of its GDP. Debt grew to $6.8 billion in 1984, more than 85 percent of its GDP that year (Berthélemy and Bourguignon 1996: 70).

Côte d'Ivoire came to resemble the traditional society described by Karl Polanyi in *The Great Transformation*. The economy is dominated by a unified political organization and not by individual and diverse decisions made by entrepreneurs (Polanyi 1945). Indeed, Côte d'Ivoire society is similar to the social structure of the pre-colonial states of the Gulf of Guinea in which an all-powerful minority obtained its wealth by serving as the intermediary between the local population and the outside world. The discourse, the rhetoric, and the goods involved have changed, but the reality of power and the flow of goods and money resemble Africa at the time of the gold, gum, and slave trade (see Hopkins 1988).

"Through the powerful central government, under the direct and sole control of the president, and through numerous state-owned enterprises, the public sector plays a major role in Côte d'Ivoire," write Berthélemy and Bourguignon (1996: 11), the authors of the World Bank's latest book on the country. The power of the central government enables Côte d'Ivoire's urban elite to preserve its domination over the country by holding back rural development. It extracts most of the benefits generated by the agricultural sector, which is composed of small, dispersed, and powerless peasants.

The tool of control is the state agency that serves as the intermediary between agricultural producers and the international market, the Caisse de Stabilisation et de Soutien des Prix des Produits Agricoles (CSSPPA). This agency is the only authorized buyer of coffee and cocoa, and the one that sells these products on the international market.

According to Berthélemy and Bourguignon (1996: 30), "Initially, the CSSPPA was to be only a price stabilization device and an instrument for controlling export crop markets." However, "with the

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increase in coffee and cocoa world prices in the mid-1970s, it became an additional source of revenue for the government and virtually abandoned its original stabilizing function." Between 1960 and 1990 CSSPPA made significant profits every year except for 1972, 1989, and 1990. This profit was achieved by fixing the prices to the producers at a much lower level than the prices on the international market. In 1984 and 1985, coffee and cocoa producers received on average only 37 percent of the international prices paid to the CSSPPA.

The Role of the World Bank up to 1980

The government has been the principal obstacle to the growth of the Côte d'Ivoire economy and the improvement of its inhabitants' welfare. But the government would probably not have been such an obstacle without the complicity of the World Bank. At first the World Bank was misled by its own analyses; but later, when these analyses were replaced by more accurate descriptions of the economy of Côte d'Ivoire, its intentions were undermined by the interests of the World Bank personnel working closely with the Côte d'Ivoire government.

In 1978, a World Bank book written by Baastian den Tuinder, *Côte d'Ivoire: the Challenge of Success*, analyzed the development of Côte d'Ivoire since the turn of the century. In Tuinder's view, the nation's economic success was exclusively due to the state—the French state during the colonial period and Houphouët-Boigny's after independence. The take-off of coffee and cocoa production was the result of the agricultural policy put into place by the colonial extension service, and all the credit for the spectacular growth of the economy during the 1960s went to the government's economic policy.

Tuinder thought that the nation's economic problems in the late 1970s, such as its nondiversified economy, unequal income distribution, and low return on investment, were well on their way to being solved. The state was moving in the right direction, he thought, and the best proof was the increase in state investment, which went from 40 to 60 percent of total investment between 1960 and 1970. This increase in the government's role, Tuinder thought, would also help diminish social and income inequalities.

Tuinder's book reflected the views of mainstream development economists at the time. According to them, economic growth depended on the deliberate action of the state in the form of a national development plan. The World Bank's intervention in the Côte d'Ivoire economy exactly fit the analysis developed by Tuinder. Its main goal was to strengthen state institutions in order to promote more "coherent" economic policies.

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However, national planning in Côte d'Ivoire had unfortunate consequences, especially since the government was a one-party state, with no opposition allowed. Centralized planning enabled the people in power to control the allocation of resources and the distribution of wealth. The World Bank became the ally of government officials, providing them with financial resources when the state budgetary deficit got too large.

The Early 1980s: The World Bank Analysis Changes

Beginning in 1982, however, a different analysis of the Ivorian economy began to emerge from the World Bank. A series of economic studies were published in the World Bank's "Working Papers" series focusing on specific sectors of the Côte d'Ivoire economy such as industry, agriculture, social services, education, and health (Glewwe 1987, Glewwe and de Tray 1988, Michel and Noel 1984, van der Gaag and Vijverberg 1987). Most were written by relatively young professionals who relied on microeconomic analysis rather than the macroeconomic theories of development prevalent in the 1950s and 1960s.

Many of the studies viewed the government's economic policy not only as an obstacle to recovery but, in fact, as the cause of the nation's economic problems. Above all, the World Bank analyses blamed the CSSPPA. According to the new World Bank analyses, the CSSPPA's price controls diminished economic diversity, encouraged rural outmigration, and contributed to income inequality. They led to excessive debt and the inability to service it. The World Bank began to press the Côte d'Ivoire government to pay higher producer prices.

The conclusions of these studies (and their facts as well) differed widely from Tuinder's. While Tuinder had classified Côte d'Ivoire as a country with a relatively even distribution of income (with 19.7 percent of national income going to the poorest 40 percent of the population), these more in-depth studies revealed that the poorest 40 percent received only 8.6 percent of total income. Indeed, Côte d'Ivoire was classified as the African country with the most unequal distribution of income.

Tuinder had described Côte d'Ivoire as the country in the world that devoted the highest proportion of its budget to education, but the World Bank studies of the 1980s showed that between 50 and 80 percent of the education investment went to higher education and that the cost per student at the university level was among the highest in the world. Because university students came mainly from the richest families, primarily located in Abidjan, this spending pattern reinforced

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social inequalities. So, in spite of the large amount of capital allocated to education, 40 percent of the children between ages 6 and 12 were not attending school in 1985.

The World Bank also revealed that health spending went mainly to the wealthy urban population. Rural populations, which in 1984 accounted for 50 percent of the total population, received only 11 percent of the health operating budget. Most of this budget paid for highly sophisticated treatments not suited to the needs of the majority of the population, who needed low-cost preventive care. In sum, the World Bank's health, education, and housing studies demonstrated that government policies had benefited the rich at the expense of the poor.

The newly emerging World Bank analyses applied to other countries as well. The World Bank concluded that the more interventionist the state, the slower the rate of economic growth and the more unequal the distribution of income. As Keith Marsden (1983: 2) wrote in a study of 20 countries, "In all cases, the countries that imposed a lower effective average tax burden on their populations achieved substantially higher real rates of growth of gross domestic product (GDP) than did their more highly taxed counterparts." The higher rates of economic growth, he wrote, "allowed a substantial rise in real living standards in the low-tax countries, shown by their higher levels of private consumption" (p. 4).

The sectoral studies served as foundations for the document issued by the World Bank in 1986 under the title "La Côte d'Ivoire en Transition: de l'Ajustement Structurel a la Croissance Autonome." This document defined the position of the World Bank in the negotiations it was holding with the Côte d'Ivoire government on the Third Structural Adjustment Loan. And, as it had in 1985, the World Bank in 1986 argued that the recovery of the Côte d'Ivoire economy required a disengagement of the state from the economy and urged that the state pay higher coffee and cocoa prices to producers.

The Middle 1980s: Conflict over Reforms

Once the World Bank began to propose reforms consistent with its new analysis of the Ivorian society, it became a threat to the well-being of those involved in the government. But it failed to deliver on this threat. This became clear in the autumn of 1986.

The prices paid to coffee and cocoa producers were fixed every year by the head of the state at the beginning of the harvest season, in September. In the fall of 1986, the new prices were announced during the preliminary negotiations with the World Bank for the Third

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Structural Adjustment Loan. In spite of clear statements by the World Bank that these prices should be raised, they were not. Yet a few months later an agreement was reached, and Côte d'Ivoire received its Third Structural Adjustment Loan.

For the next four years, the World Bank was divided in its treatment of Côte d'Ivoire. Rhetorically, it demanded reforms. In practice, reforms were never implemented and the World Bank kept lending more to the Ivorian government.

In response to the apparent World Bank pressure, the Côte d'Ivoire elite developed a strategy of nationalistic and Third-World-style rhetoric. Government officials pictured the World Bank as an instrument of the international policies of the rich Western countries. The bank, they contended, was defending the interests of the "North" against those of the "South." Its attempts to promote a national economic policy based on comparative advantage was described as a way of keeping poor countries dependent on rich industrial countries, maintaining the status quo. The leaders contended that the World Bank wanted Côte d'Ivoire to produce coffee and cocoa at the expense of its industrialization.

They cited as evidence the riots in other poor countries after the adoption of policies advocated by the World Bank, such as higher prices of food and other basic commodities. With this strategy, the ruling class won over the populace. Such a position found a friendly echo in the media of the wealthier countries, which have tended to downplay criticism of the post-colonial governments of sub-Saharan Africa.

Why Did the World Bank Fail to Insist on Reform?

The reforms proposed by the World Bank were designed to restore economic growth to Côte d'Ivoire. Although there is controversy over whether the reforms would have reduced government power sufficiently to allow the economy to move forward, they would have been a step in the right direction. However, the World Bank failed to require the Côte d'Ivoire government to implement them.

There are two reasons for this failure. One is related to the international political position of Côte d'Ivoire.

Since its independence in 1960, Côte d'Ivoire has followed a pro-Western international policy. This and the fact that it had only one leader, Felix Houphouët-Boigny, affected the behavior of the World Bank toward Côte d'Ivoire. The financial debt of Côte d'Ivoire to the Western countries is partly balanced by the political debt that the Western countries hold to Côte d'Ivoire for constant international

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support, especially in African international politics. This aspect of World Bank behavior is beyond the scope of this article.

Equally important, however, was the role of World Bank personnel. An understanding of their incentives and their relationship with the leadership of Côte d'Ivoire helps explain the failure of the World Bank to take action in line with its own recommendations.

The professionals who conducted the studies recommending higher producer prices were by and large different from the staff who negotiated the loans. These two groups interact only marginally, and when they do, it is in the early stages of the negotiation process. The bank's professionals are quite similar to scholars in the research and university community. Their work is evaluated and appreciated mostly by academics and, like academics, they depend largely on publication of scholarly articles for their promotion opportunities. This incentive structure gives them an independent viewpoint (mitigated only by ideology or school of thought). Their incentive structure makes them somewhat aloof from the internal power structure of the bank as well as from the role of the bank in international politics. They are part of the bank, but their professional status is not completely dependent on the bank.

In contrast, the personnel in charge of lending and negotiations are essentially administrators. For the most part, they are former civil servants in their country of citizenship or former administrators of other national or international financial institutions. Their careers and promotions are closely linked to the power of the institution they work for and the size of its budget.

The bank has a bureaucratic incentive to lend money (otherwise, what purpose would it have?), and merely extending loans increases these officials' chances of controlling a larger-sized budget the next year. For the most part, their professional success is not determined by the return on the capital loaned. This incentive structure pushes World Bank personnel to lend money even when the borrowing country fails to meet the conditions required to make this flow of capital productive.

Côte d'Ivoire civil servants who deal with the World Bank are high in the civil service hierarchy, and often also hold a political position inside the dominant party. Their personal welfare depends on the maintenance of the status quo. Their power and their fortune are a function of the amount of taxes collected by the state and of the level of government expenditure. If expenditures exceed revenues, little harm comes to them, especially when the deficit can be made good by foreign bank loans. They are ready to commit substantial resources

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to resist any attempt to diminish the control of the state over the economy, since this would bring a substantial loss of power and wealth.

The interests of the Côte d'Ivoire leadership meshed well with the interests of the World Bank administrators. The World Bank was the main creditor of Côte d'Ivoire, and hence the most important and reliable source of power and revenue for these civil servants. The defense of their interests encouraged them to find compromises with the World Bank. This was made easier by the fact that the personnel of the World Bank in charge of lending also had a strong incentive to compromise, making sure that Côte d'Ivoire received its loans regularly. This left ground for bargaining, and the goal of the Côte d'Ivoire ruling class was to obtain these loans at a minimum cost to their well-being.

So, throughout the 1980s both parties were strongly motivated to find an agreement and a "positive" outcome to loan negotiations. This did not prevent the negotiations from going through different stages reflecting the rites associated with the exercise and enjoyment of power. At times it looked as though negotiations might break down and the loan would not be granted. But in the end the similarity of interests was so great that an agreement was regularly found.

Political Power, Economic Growth, and the Market Economy

Societies that experience a sustained increase in per capita income over a significant period of years are rare. In their provocative work on *How the West Grew Rich*, Nathan Rosenberg and L. E. Birdzell (1986) demonstrate that, over centuries, the gradual breakup of centralized political controls stimulated sustained economic growth. The disintegration of central controls allowed autonomous economic activities to proliferate.

In countries such as the Côte d'Ivoire, the allocation of material goods is determined by political authorities. This political allocation introduces a discrepancy in most economic activities between the private rate of return and the social rate of return. The government of Côte d'Ivoire pays farmers less than the value of their coffee and cocoa, discouraging socially valuable production. It supports expensive but unrewarding industrial projects, activities with a low social value.

Economic growth is possible only with an institutional arrangement that brings the private rate of return close to the social rate of return. The more prevalent these discrepancies, the less likely it is for a society to experience economic growth. Yet by promoting and maintaining these discrepancies, the group in power optimizes its own

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welfare. As Polanyi wrote in *The Great Transformation*: "A self-regulatory market demands nothing less than the institutional separation of society into an economic and a political sphere" (Polanyi 1945: 72–3). Hence there is a fundamental contradiction between authoritarian regimes and economic growth, because authoritarian regimes at some point will constrain the emergence of a market economy.

Once past its infatuation for "development planning," the World Bank at the beginning of the 1980s recognized that the Côte d'Ivoire state had become the principal obstacle to economic growth, primarily through its monopsonistic practices. The bank correctly concluded that the government should loosen its grip on the economy. However, in reality and in practice, the intervention of the World Bank did not contribute to this disengagement. The very logic of its functioning prevented it from having a beneficial influence on Côte d'Ivoire society. The relations it established with Côte d'Ivoire authorities allowed, in fact, for a strengthening of the political control over the economy.

After the late 1980s, the economy of Côte d'Ivoire went from bad to worse. Its per capita gross domestic product fell 4.3 percent per year between 1985 and 1994 (Gwartney et al. 1996: 94). As before, the blame for this disastrous economic performance is being placed on external conditions, especially low coffee and cocoa prices (Berthélemy and Bourguignon 1996). However, this misses the point. Had the multitude of Côte d'Ivoire's small entrepreneurs not been heavily taxed from 1960 to 1988 by a predatory ruling class through the CSSPPA and had not this predatory ruling class been helped to hold on to power by the World Bank through a continuous inflow of capital, today's economy would be more diversified and better armed to face these adverse conditions successfully.

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Deregulated Private Water Supply: A Policy Option for Developing Countries

Penelope Brook Cowen and Tyler Cowen

The Privatization Alternative

Many citizens in developing and transition economies are excluded from enjoying safe and reliable water supply. In many cities, 30 to 60 percent of the population has no formal water hook-up at all, but rather must resort to wells, buckets, supply by tanker-trucks, and physical transport of water through human labor and beasts of burden.

A few simple facts illustrate the serious nature of this problem. In Jakarta, 75 percent of the population has no formal connection; in Maputo 65 percent. In Madras, the percentage served is around 50 percent; and even in relatively prosperous Manila, 29 percent of the citizenry has no connection. When individuals must resort to nonpiped water sources, prices are often at least 10 to 20 times higher. In Luanda, where the price for piped supply is around nine cents per cubic meter, households can pay as much as $16.00 per cubic meter for tanker supply. Table 1 portrays some connection rates and price differentials.

The fundamental problem is institutional rather than technological. Tariffs set by governments at levels below cost recovery fail to encourage inclusion. In developing countries, water utilities recover on average around 30 percent of their total costs (World Bank 1994). As a

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Cato Journal, Vol. 18, No. 1 (Spring/Summer 1998). Copyright © Cato Institute. All rights reserved.

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TABLE 1

PRICES FOR PIPED AND VENDOR SUPPLIES IN SELECTED DEVELOPING COUNTRIES

City and Year	Percent without Connections	Price for Piped Water (US cents/m^3)	Price for Vendors (US cents/m^3)
Bandung (1991)	61	9.9	616
Jakarta (1991)	75	17.2	185
Manila (1992)	29	10.5	187
Karachi (1992)	17	7.5	175
Ho Chi Minh (1991)	35	7.6	151

SOURCE: Asian Development Bank (1993).

result, utilities have no incentive to deliver services to large sectors of the population, almost always low-income households. Incentives for research and development are similarly weak, given that the price-controlled monopolist cannot capture the full benefits of a new product idea.

The human costs of these institutional arrangements have been very high. According to one estimate (the World Health Organization, cited in Cooper 1997), contaminated drinking water accounts for 80 percent of disease in India, including a sizable share of the 500,000 Indian children who die each year from diarrhea. Around the world, diarrheal diseases kill more than 3 million people annually, and cause approximately 900 million episodes of illness (World Bank 1992).

We propose that unregulated privatization be considered as one means of limiting these tragedies. To date, the world has experimented with four kinds of institutional regimes: outright public provision of water (common throughout the world), government-supported natural monopoly with regulated price (the English model), government-supported natural monopoly with regulated rate of return (the American model), or a government-controlled franchise, lease, or concession agreement (the French model and its variants). We add a fifth possibility: complete privatization of water assets and unregulated natural monopoly. This scenario involves no price regulation, no rate of return regulation, no residual government ownership of assets, and no surreptitious regulation through antitrust law.

The rationale for unregulated privatization is straightforward. An unregulated private monopoly would have an incentive to bring as many potential buyers into the system as possible, so as to maximize profit. Unregulated private monopolies could thus significantly

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increase the number of water connections in developing countries. If unregulated privatization could produce hook-ups for currently neglected low-income customers, the poor would end up with higher real incomes, better water service, more time for other endeavors, and a greater probability of a long life. London water supply in the early 18th and 19th centuries, which was private and relatively unregulated, had a favorable record for extending the number of connections (see Dickinson 1954: 102–3).

While standard theory emphasizes the output-restricting nature of monopoly, water utilities will use price discrimination and fixed hook-up fees (Oi 1971) to capture as much profit as possible, thereby increasing supply in the process. Unlike the governmental and regulated alternatives, a private unregulated monopoly also would have strong incentives to hold down costs and supply an optimal quality of product. Our main point is that this monopolistic alternative deserves serious consideration.

In a comparative institutional context, the more heavily regulated alternatives may end up excluding more potential buyers. Developing or transition economies, regardless of their historical background or geographic locale, tend to share common problems with their governments. These governments have relatively low levels of credibility, weak track records, and very short time horizons. The government performs especially poorly as an owner or regulator, partly through lack of experience and partly through improper incentives and corruption.[1]

In Guinea, for example, progress under a water lease has been hampered by problems in defining and implementing the regulatory function, and by continuing disputes between the government-owned water holding company and the private water operator over who is responsible for failures in service expansions and water loss reductions. While the lease contract has increased the number of connections and improved water flows, progress has fallen short of expectations (Brook Cowen 1996).

Unregulated privatization has received little serious attention, and has generally been rejected or dismissed, albeit without serious analytical consideration. Few sectors have been classified as market failure more universally than the supply of water to households and residences. Throughout the world, water systems are characterized by extensive government ownership or thorough regulation and control. Water supply typically is regarded as a natural monopoly, and therefore a poor candidate for unregulated market provision. In the technical

[1]See, for example, Zajc (1996) on the incidence of these problems in transition countries and their implications for water privatization.

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literature, Guislain and Kerf (1996) restrict their discussion of infrastructure privatization to concessions and divestitures accompanied by a regulatory license. Klein (1996) takes as a starting assumption that the weakness of competitive pressures in the water sector creates a need for at least some form of regulation. Breyer (1982: 17) considers a price-discriminating natural monopolist briefly, but does not explore the unregulated alternative in depth. Loeb and Magat (1979) attempt to replicate private price discrimination through regulation; their scheme has the government award monopolists for the consumer surplus they generate. Armstrong, Cowan and Vickers (1994) essentially argue that if competition is not possible, regulation will be necessary.

In the remainder of the paper , we provide an analysis of potential sources of inefficiency in water markets, explain why government ownership and regulation have failed to provide fully satisfactory results, discuss how unregulated privatization might resolve the efficiency problems that plague regulation and government ownership, consider the ability of an unregulated monopolist to price discriminate when selling water to residential users, and focus on some residual problems with the proposed policy option of unregulated private natural monopoly. We find that the case for unregulated privatization is not conclusive, but that the proposal deserves serious consideration.

Sources of Efficiency Loss

The relevant natural monopoly problem comes from the distribution of water rather than from water itself. Water, considered apart from the problem of distribution, satisfies the traditional definition of a private good—nonrivalry in consumption. If one person consumes some water, another person cannot use the same water. While there are public health benefits to a clean water supply, the private benefits of clean water are high as well, giving individuals a strong incentive to pay for water quality. Consistent with the private-good nature of water, we observe the efficient private supply of water in a variety of circumstances. We buy bottled water at the supermarket, and private, for-profit car washes supply water to clean our cars. The private sector has had considerable success in supplying and running wells, at least where wells are a reasonably efficient means of water delivery.

The construction and maintenance of water distribution networks presents the difficult problem, and the potential cause of market imperfection. Once a system of water pipes is built, the owner of the system has a monopoly advantage in the market. If only one set of pipes exists, the owner of those pipes can exercise market power and

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charge a price for water in excess of its marginal cost. As discussed above, other means of obtaining water, such as water delivered by tanker-vendors, typically involve costs from 10 to 20 times higher than buying water through a piping system. Alternatively, we might imagine a system of competing pipes, or competing pipe systems. Such systems did occur in Canada and the United States in the 19th century, and do still occasionally arise when water of different qualities is being supplied. For example, in Hong Kong seawater pipes supply flushing water (Klein 1996). In this case, however, consumers ultimately must finance both piping systems. The high prices needed to recoup the costs of multiple piping systems will imply a restriction of water output, just as the monopoly did. Furthermore, the stability of market equilibrium is problematic when multiple, competing suppliers own networks with high fixed costs (Bittlingmayer 1982). Competition will tend to force prices back down to marginal cost, but at marginal cost no supplier can break even and recover the fixed costs spent on constructing the piping system.

Some treatments emphasize market means of overcoming the natural monopoly problem. Under one proposal, water is distributed through a club-owned network, with different suppliers competing against each other to win contracts with consumers. Either the suppliers or the consumers themselves own or control the club. We see merit in this idea, but for the purposes of exposition we assume that the natural monopoly problem cannot be overcome so easily. The potential ability to make the market competitive, however, would only favor our basic proposal.[2]

Assuming that competition is not possible, the fundamental problem involves the construction of a distribution network with fixed costs that are high relative to marginal costs of supply. The problem behind the private provision of water thus resembles analogous problems with the sale of cable television services, electricity, and natural gas.

Institutional regimes for water provision face three kinds of efficiency problems: inefficient levels of output, inefficient levels of cost, and inefficient levels of product quality. A non-price-discriminating monopolist, in the absence of regulation, will set price above marginal

[2]We also see some problems with the club proposal. Even if many suppliers compete by selling water services through a single pipeline, the fixed costs of the pipeline still must be covered somehow. Competitive pricing allows no means of financing the pipeline and allowing each company to break even. Presumably some kind of Ramsey pricing is necessary, where inelastic demanders face the highest mark-ups, but this introduces some of the welfare losses of market power. Along other lines, Demsetz (1968) analyzed ex ante competition "for the market." In this proposal utilities offer competitive bids to communities for water supply; see below for a discussion of franchising.

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cost and restrict output, compared to a first-best social optimum. That is, consumers would be willing to pay more for additional units of output than it would cost society to produce them. The monopolist does not expand output, however, because the extra units of output could be sold only by lowering the price for all units and thus reducing profits.

Regulators have found it difficult to address this problem of monopoly without inducing other distortions. One approach grants private ownership but places a cap on price (the British model for water provision). Placing a cap on price, however, gives the private supplier an incentive to skimp on service and product quality. As with all price controls, the supplier will raise the real price to its desired level by lowering the quality of the product. Not only will quality decline in the short run, but long-run investments in system maintenance will be suboptimal. As discussed above, this problem is particularly drastic in developing and transition economies.

An alternative method of regulation, common in the United States, uses rate of return caps to limit the profits of the private monopolist. In practice, rate of return regulation usually involves price caps as well, whether implicitly or explicitly, and in that regard also leads to skimping on service and product quality. Furthermore, rate of return regulation brings a new set of distortions in the form of higher costs. As rate of return regulation is practiced, firms typically are guaranteed a minimum as well as a maximum rate of return. Without the minimum guarantee firms would not participate in the arrangement, given that they have sacrificed upside potential for profit. Firms therefore can use cost increases as a justification for price increases; not surprisingly, the incentive to keep down costs is low. The end result is high costs and a lower level of water consumption than is optimal.

Leasing and concession agreements, in their various forms, provide yet another attempt to overcome the basic problem with natural monopoly. These institutional arrangements, however, do not avoid the fundamental problems associated with regulation. Leasing and concession agreements typically regulate prices and rates of return to various degrees, either implicitly or explicitly. In this regard they involve the welfare losses associated with price and rate of return regulation. Leasing and concessions may provide for a looser or more informal kind of regulation, given the ongoing relationships between the water company and the relevant government, but in the final analysis either the supplier is free to adjust its prices or it is not. If prices can be set freely, we return to de facto unregulated natural monopoly (of course this may be an advantage of concessions, as will be discussed below). If prices and rates of return are not free to adjust,

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we return to the distortions of regulation and the weak incentives to expand the number of system hook-ups. Particular problems arise where concession contracts mandate expansions into low-income areas, while also mandating "life-line" (below-cost) tariffs for low-income consumers.

Leasing and concession agreements involve further distortions through the government's role as residual asset owner. As the leasing or concession agreement nears an end, the private concessionaire has an incentive to cease maintenance or even strip the water assets. Leasing works poorly when the company faces a short time horizon. The government can alleviate these problems by promising a forthcoming renewal of the lease, or by offering comprehensive provisions for compensation upon contract termination, but if these promises are credible, leasing and concessions do not differ greatly from asset privatization with regulation. If the promise is not credible, we return to poor incentives for maintenance[3].

A fourth proposal involves outright government ownership of water assets and full governmental control. The record of governmental provision in this sector, however, is extremely poor. In developing countries, where government ownership has been the norm, tariffs are routinely set well below cost recovery levels, routinely less than half of supplied water is actually paid for, and large segments of the population go without formal services (World Bank 1994). For political reasons, governments have weak incentives to reduce costs, price water at marginal cost, maintain water systems, introduce innovations, and cut staffing to efficient levels. Not surprisingly, countries around the world are moving away from the government ownership option, and embracing various forms of private sector participation (Rivera 1996). Table 2 shows examples of private sector contracts that are now in place.

Sketch of an Unregulated Natural Monopoly for Water

Consider a scenario where a government allows complete private sector ownership of all water system assets, including the impounding of bulk water, water treatment, and distribution. The private sector would own all water system assets (which may or may not be vertically integrated) just as the private sector owns the assets in the automobile industry or the computer industry. Furthermore, suppose that the

[3]Zajc (1996) provides a comprehensive survey of the efficiency problems with concessions and leases.

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TABLE 2

EXAMPLES OF PRIVATE SECTOR ARRANGEMENTS IN WATER AND SANITATION

Contractual Type	Water	Sanitation	Water and Sanitation
Management Contract	Colombia Gaza Malaysia Turkey	United States	Puerto Rico Trinidad and Tobago
Lease	Guinea Italy Senegal Spain		Czech Republic France Poland
Build-Operate-Transfer	Australia China Malaysia Thailand	Chile Mexico New Zealand	
Concession	Côte d'Ivoire Macao Spain	Malaysia	Argentina France Philippines
Divestiture	England and Wales		England and Wales

SOURCE: World Bank (1997).

owner of the water assets could set prices and quantities without regulatory interference. Water suppliers and customers would rely solely on contract to set the terms and conditions of water delivery, and the courts would agree to uphold any contracts which are written. The absence of regulation, as defined in this paper, also implies a credible laissez-faire antitrust policy with regard to pricing and output decisions. If water companies set their prices with an eye to avoiding charges of "anticompetitive behavior," or "price gouging," we would return to an implicit form of price regulation. The laissez-faire antitrust policy also would allow complete freedom of merger and cooperative relations across differing firms.

Our use of the term "unregulated" refers to the absence of a set of government regulations found in today's regimes—specifically, restrictions on asset ownership, pricing, service delivery, etc., and exclusivity arrangements. Under laissez faire, the provision of services is regulated by market forces and economic incentives. In this sense

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our analysis compares one kind of regulation to another, rather than comparing regulation to an unregulated state of affairs. Furthermore, all regimes possess an implicit form of government regulation through ex post liability law. In the scenario we consider, private water suppliers would remain liable to lawsuits for breach of contract, fraud, or provision of water of dangerous quality. Nonetheless we continue to use the word "unregulated" for purposes of expositional simplicity and for lack of a more accurate descriptive term.

The forces for natural monopoly within a single geographic area would be strong in an unregulated environment. Experience suggests economies of scale in the operation of distribution networks for populations of at least 50,000 to 100,000 people. Economies of scale in system management as a whole are more extensive (evidence from Britain indicates that managerial economies of scale are exhausted at populations of 500,000 to 1 million). The natural monopoly may be limited at certain margins, such as when industrial users develop their own wells. At the residential level, some households may find it more profitable to dig wells, or to collect and store rainwater for at least some uses. For the typical residential user, however, we envisage a situation where water can be obtained at lowest cost from a single dominant supplier within that geographic region.

We expect suppliers to offer standard packages to their consumers. If an individual is building a house, the water supplier will offer to outfit the house with pipes for some fixed sum, perhaps based on the value of the house and the neighborhood. Where real estate developers are responsible for installing household connections, they routinely use this approach. If a house is already in place and already possesses a hook-up (perhaps as a legacy from a previous, regulated regime), the water supplier will offer so many units of water at a given price, so many more units at another price, and so on. Households will either accept or reject these offers, depending on the promised bundle of price and service.

The water company has strong incentives to set initial offers that will be accepted. The company will try to capture as much surplus from each household as possible, but the company also wishes to ensure that each household signs up to purchase water. Given the initial assumption of natural monopoly, the company can serve subsequent households at relatively low marginal cost. Note that in the polar case where the company has perfect knowledge of household demands, and can precommit to a series of price offers, a "first-best" result will obtain. The water company will extract all of the consumer surplus associated with water purchases. We do not present the first-best as an attainable real world outcome; the relevant comparison is

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between imperfect markets and imperfect government regulations. Nonetheless, presentation of the first-best illustrates some basic incentives behind unregulated monopoly and also serves as a foil, by contrast allowing us to see ways in which unregulated monopoly falls short of an ideal outcome.

The relevant consumer surplus can be extracted in either of two ways. The company may charge a fixed fee for a hook-up, and then sell remaining water units at marginal cost over some specified period of time. Both the fixed fee and the subsequent per unit prices would be determined by initial contract; Oi (1971) has analyzed the efficiency of this arrangement. Alternatively, if the hook-up is already in place, or if it is too costly to bargain over the hook-up fee, companies will simply supply the hook-up and then sell water at some price above its marginal cost of production.

This situation, if it can obtain, solves all three of the efficiency problems discussed above. First, the supplier will produce a socially optimal amount of output. For any unit whose value exceeds its marginal cost, the supplier will produce it and offer it on the market. With perfect price discrimination, a supplier never increases profit by withholding output from the market. Second, the supplier has first-best incentives to engage in cost reduction. Any reduction in costs translates into a one-to-one increase in profits. Suppliers therefore will reduce their costs to the point where the social benefits of cost reduction equal the social costs. High costs cannot be socialized but rather eat directly into profits. Third, a perfect price-discriminating monopolist has first-best incentives with regard to product quality. The supplier captures all of the consumer surplus in the form of profits. That same supplier will therefore offer the product qualities that maximize consumer surplus, net of the cost of production.[4]

The ability of a natural monopolist to perfectly price discriminate may be problematic, under a variety of assumptions. For that reason the first-best results may not strictly hold. Nonetheless an unregulated, privatized natural monopoly obtains first-best results under the basic assumption that the water company succeeds in maximizing its profit. Even in a second-best setting, the monopolist may produce a greater quantity and quality of water outputs than do today's highly regulated alternatives. In most developing and transition economies the key problem is to get users some minimal amount of clean water, not to satisfy all optimality conditions.

Note that the potential efficiency of price discrimination also indicates why leasing and concession agreements, and divestitures with

[4]Phlips (1983) provides an overview and survey of the economics of price discrimination.

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a license, may sometimes result in first-best or near first-best outcomes. If the company holding the concession has sufficiently cozy relations with the host government, that company may be given latitude to replicate the efficient price-discriminating natural monopoly outcome. Quantity and quality decisions will again be optimal, if the "unregulated" outcome can be obtained under the guise of regulation. In practice, however, governments frequently impose uniform tariff rules, or otherwise restrict price discrimination by regulated private water companies.

The Feasibility of Price Discrimination for Water

Price discrimination is most feasible when four primary conditions hold. First, the seller must hold some degree of market power. Second, the product cannot be vulnerable to low-cost resale from low-price buyers to high-price buyers. Third, the seller must be able to make good estimates of buyer demands. Fourth, the supplier must be able to commit to initial price offers. Each of these assumptions characterizes the water market to some degree.

We take the presence of market power as given, and as following from the natural monopoly assumption. If somehow no market power were present, price discrimination would be impossible, but a regime of unregulated private water supply would in any case prove effective.

The absence of cheap resale from low-cost to high-cost buyers also follows from the natural monopoly assumption. By construction of the example, it is much cheaper to sell the water through a system of pipes than through bottles, wells, and buckets. Even if some resale were possible, however, market demands would shift without changing the fundamental nature of the problem. Assume, for instance, that in the absence of resale low-valuation buyers would be charged $20 and high-valuation buyers would be charged $100. Now consider resale, which is profitable at any price above $80 to the high-valuation buyers. The high-valuation buyers will refuse to pay more than $80, and the price-discriminating monopolist must lower prices accordingly, presumably to just below $80. Even at this lower price an optimal quantity of output is still produced, and the monopolist still has full incentives to economize on costs at the margin. Optimal quality cannot be guaranteed, since the monopolist cannot necessarily reap the full benefits of a quality improvement (higher prices for quality improvements may be undercut, implying that the innovator cannot reap all of the new consumer surplus that is produced), but some incentives for quality improvement remain nonetheless.

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The third and perhaps most problematic condition for effective price discrimination is whether the seller can predict the market demands of the buyers. The water supplier will estimate two differing features of water demand: how much a given buyer values having any water connection at all, and how much a given buyer values subsequent units of water. We envisage a market where the water supplier sets price by examining the previous use patterns of the water buyer, the value of the water buyer's property, and the wealth of the neighborhood. In wealthier areas the supplier may consider the number of bathrooms in the house, whether the water buyer has a lawn, and other pieces of ancillary information, such as the water buyer's age, job, or credit record.[5] Insofar as water demand is closely correlated with observable characteristics of the property and the buyer, effective price discrimination will be relatively easy. The water supplier will run information on the buyer and the property through its "pricing office," which will respond with a suggested price offer, both for initial service and for successive units of water use. In Los Angeles, for example, the water department has the capacity to customize base tariffs across consumers, according to such factors as lot size, temperature zone, and size of household (Mann 1996).

Price discrimination will inevitably be imperfect in practice. Prices sometimes will be set too high, thereby excluding buyers from either participation in the piping network or from the purchase of additional units, even when the social benefits of added output would exceed the social costs. While some inefficient exclusion will occur, water supply may well be higher than under most current regimes in developing economies.

Even when suppliers make pricing mistakes, they need not exclude buyers altogether. To the extent that monopoly power is considerable, price will exceed marginal cost by a large amount, and the profits of water sales will be large. Each excluded buyer represents a chunk of foregone profit. Consider the position of a water company which believes that a given buyer values regular water use at, say, $1,000, and where the company can produce those same water services at a cost of $300. If the company knows that the buyer's valuation is in the neighborhood of $1,000, but the company is not sure about the exact valuation, the company will more likely price the services too low rather than too high. If the company charges $1,001, it loses $700 of potential profit. The expected return to guessing low will tend to exceed the expected return to guessing high. The microeconomic

[5]Since U. S. public utilities routinely run credit checks, this need not involve a significant loss of privacy.

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intuition here is simple: individuals or institutions which face a good chance of capturing a significant prize will behave cautiously when they are within range of winning the prize. For similar reasons, monopolistic firms in other contexts will choose high levels of product safety, reliable service, and easy access to their product, all in the desire to protect their monopoly profits (Klein and Leffler 1981).

The excluded buyers will tend to be those whose valuations do not much exceed the marginal cost of producing water services. If the marginal cost of production is $300, and the buyer values service at $320, the firm has less marginal profit to lose by trying to squeeze out all of the buyer surplus. Some of these buyers may end up excluded, since the firm will sometimes guess incorrectly and offer a take-it-or-leave-it price above $320. Even when exclusion results, however, the welfare costs of this exclusion tend to be relatively low. In the example, the buyer valued the product only slightly more than its marginal cost of production. When expected profit, and expected social surplus, are low, fewer resources will be spent trying to capture that profit and some potential gains from trade may be foregone.

If such resulting instances of exclusion prove unacceptable, perhaps for reasons of fairness or equity, a government may decide to intervene in the market and require service to low-income buyers at prices they can afford. In this case our proposal would cease to be purely unregulated, and would involve the costs of price controls, at least for some buyers or some neighborhoods. This outcome, however, represents a worst case scenario for our proposal, which still appears to provide superior overall performance, compared to a regime with full regulation across all contracts and all buyers.

Many cases of harmful exclusion will come in the form of overpriced marginal units, rather than overpriced fees for basic hook-ups. Companies often will choose price discrimination in the form of a schedule, where the prices for water services vary with the quantity consumed. Assume that a buyer values the first unit of water services at $100, the second unit of services at $60, and the third unit at $30. The company will try to offer a price schedule that matches these demands exactly, but if the company calculates demand incorrectly, it may offer, for instance, a schedule of $100–$60–$40, thus excluding the buyer from the third unit of water services. The buyer will take shorter showers than would be socially optimal, but some amount of safe water will still be supplied.

Fragmentary data and lack of experience with unregulated privatization prevent us from offering an empirical assessment of the relative magnitudes of these exclusion costs across institutional regimes. Nonetheless we see no prima facie case for dismissing the unregulated

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alternative. The unregulated monopoly has a continual incentive to reduce exclusion problems, whereas the regulated monopoly does not, and may even have an incentive to increase costs and therefore prices, such as under rate of return regulation.

The foregoing discussion has assumed that water companies make single, take-it-or-leave-it offers, which customers must either reject or accept. The analysis becomes more complex if the company must engage in bargaining with its customers.

Bargaining with customers may have either positive or negative effects on welfare, compared to the take-it-or-leave-it alternative. When bargaining is present, some of the initially excluded customers may receive price reductions until they are no longer excluded. Low-valuation buyers face a lesser danger of complete exclusion. On the negative side, consumers may hold out for excessively low prices, if they cannot observe the marginal cost of the firm. If the marginal cost is $30 and an individual values the service at $40, the individual may nonetheless hold out for a price of $20, in the mistaken belief that marginal cost is $19. Since customers probably cannot observe the marginal cost of the firm with great ease, the potential for such losses exists. Furthermore, some quantity of real resources will be consumed in the bargaining process. Customers may delay buying hook-ups or may try to masquerade as low-valuation buyers, for instance, or the company may invest in signaling its resoluteness as a bargainer. All of these real resource investments are made for the purpose of receiving transfers, and thus violate first-best efficiency.

We expect that bargaining costs will be a significant issue only for very large users, such as large businesses or perhaps condominial developments that buy their water services collectively. We envisage the water company as being able to commit to a price offer to individual users, rather than having to bargain on a house-to-house basis. Most unregulated large-scale suppliers of household services offer their wares on precisely such terms. If a city has only a single newspaper, for instance, that newspaper may be sold at a price above marginal cost. Yet the newspaper company does not bargain with each household, but rather can precommit to a given schedule of prices, and then sell papers to interested subscribers. We expect a similar practice to develop with water. Bargaining over prices is most likely when the purchase is occasional, rather than repeated, and when the item has significant value, such as an automobile, a home, or an expensive painting. Even in these cases, such as with automobiles, bargaining is often largely a ritual of convergence on a publicly available "book price."

Those institutions that can bargain with the water company, such as large businesses or developments, will consume some resources in

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the form of bargaining costs. Longer-term rent-seeking costs may arise as well. Individuals will be more likely to live in large condominial developments, for instance, if such decisions hold the promise of reducing their water bill. Residential decisions will be made inefficiently, as the search for transfers from the water company will lead to too many cooperative developments and too few stand-alone houses. In these regards an unregulated privatized monopoly will again fall short of a first-best optimum.

Further Issues

We see three other potential problems with unregulated privatized monopolies in the water sector: equity and distributional objectives, rent-seeking costs, and the imperfect ability of governments to precommit to a laissez-faire regime. We consider each problem in turn, and how privatization might be structured to overcome the relevant objections.

Equity

Commentators often find the distributional implications of perfect price discrimination to be disagreeable. If the water company succeeds in price discriminating, it will capture all of the produced social surplus for itself, and leave consumers with very little benefit. We do not regard this as a decisive objection to unregulated privatization for two reasons. First, it is possible to structure privatization in such a way as to prevent wealth transfers away from consumers. Second, water policy may be an inefficient means of realizing distributional objectives.

If the distributional implications of price discrimination were objectionable, the income transfer could be reversed by giving water customers an equity stake in the water company itself. The government could privatize water company assets using a Czech-style voucher plan, and send the vouchers to potential water customers. High company profits would then imply high values for the shares, thus reversing the initial transfer of income or social surplus. As long as the company continued to maximize profit, an efficient quantity and quality of water would be produced, without objectionable distributional consequences.[6]

[6]The firm may deviate from profit maximization if enough of its shareholders are customers as well. The customers, if they have enough voting power, may eschew direct profit maximization and instruct the company to mimic the price and quantities of a perfectly competitive firm. Even in this (unlikely) case, however, the water monopolist will produce a first-best outcome.

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The water market could even be used to redistribute income toward the poor, if the government distributed especially high numbers of shares to the poor (we are not necessarily recommending this policy, however). Even if a foreign company were supplying water, the government could require that company to set up a local subsidiary, and the government could then purchase shares in that subsidiary for its poor. Alternatively, the government could demand that the company distribute such shares for free, as part of the payment for being allowed to market water in the country. The government also could charge the foreign company an entry fee, up to the size of the expected profits (adjusting for risk), and rebate these funds to disadvantaged groups. Even in the absence of rebates or voucher-style privatization, the distributional consequences of unregulated privatization are unlikely to be strongly negative, and may even be positive.

To the extent that clean, potable water brings external benefits, the community will gain under price discrimination, even if the monopolist water company extracts the full consumer surplus for each individual. Each individual would fail to reap surplus from his or her water purchase decision, but the community as a whole would receive the external benefits of the additional supply. The widespread provision of clean water would help break the well-known cycle of disease, poverty, and poor sanitation that plagues so many parts of the world. From the community's point of view, the potential status of clean water as a good with positive externalities strengthens the case for unregulated natural monopoly. If water is a public good, from the community's point of view it becomes less important how much consumer surplus is retained by buyers, and more important to increase the absolute number of hook-ups as rapidly as possible.

Developed countries also are unlikely to experience significant distributional problems with unregulated natural monopoly. Households currently purchasing water from tankers are likely to face lower per unit prices once they receive a piped connection, even with price discrimination. A government also could offset any undesired distributional consequences of its water policy by changing tax rates or by using the numerous other policy instruments that influence the distribution of wealth.

Using water policy to implement distributional objectives has had an undistinguished track record. Governments often have required water companies to set price below marginal cost to achieve distributional objectives. Fortunately, such practices are now almost universally discredited, even though they continue in practice. Using pricing to achieve distributional objectives has caused many water utilities to be insolvent, and has brought unfavorable long-run distributional

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consequences as well, again as discussed above. For the same reasons that we reject the distributional argument for pricing below marginal cost, we do not accept the distributional critique of unregulated privatized monopoly.

Rent Seeking

A regime of unregulated privatized monopoly may involve significant rent-seeking costs if firms can compete for that monopoly position. In traditional rent-seeking models, the resources expended on capturing a monopoly position are exactly equal to the monopoly profits at stake. If the water company would earn an expected $500 million in profits (in present value), companies would be willing to invest up to $500 million dollars to earn that position (Tullock 1967). The more successfully a monopolist could price discriminate, the greater the corresponding rent-seeking costs. Unregulated privatized monopoly could cease to serve as a first-best optimum. We see rent-seeking costs as a potential problem for unregulated privatized monopoly. Nonetheless the transition to privatization could be structured to keep rent-seeking costs to a minimum. The theory of rent seeking implies only that the would-be monopolist will pay a sum equal to the available rents; this sum make take the form of a transfer rather than the consumption of real resources. Assume, for instance, that the government is selling or auctioning off existing water assets to private companies. The winning company will be willing to bid a sum up to the expected profit, adjusted for risk. So if expected profits are $500 million, companies will bid some sum just short of this amount (again adjusting for risk), and transfer the funds to the government. Rent seeking takes the form of a pure cash transfer and consumes no real resources. In fact, the transferred funds could be used to satisfy distributional objectives, such as cash rebates to low-income water customers, as discussed above.

Rent seeking for monopoly positions will consume real resources only when cash transfers are not available. We can imagine water companies which court the local politicians, engage in expensive advertising campaigns, and send costly signals of their trustworthiness. In all these cases the search for a monopoly position will lead to real resource consumption, and in fact we do observe all of these phenomena in the contracting process. Nonetheless, both the government and the water company will attempt to replace costly signals and investments with pure cash transfers, simply because the latter are both cheaper and of greater value to the recipient. Rent-seeking costs also can be limited by noncompetitive procurement practices. If one company stands in a favored position to win a given contract, that

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company need not invest large sums of real resources to capture the subsequent rents. When rent-seeking costs are potentially high, governments may obtain superior results by limiting entry into the profitable activity. The winning company will still be able to serve the entire market, and other companies will be dissuaded from investing resources to capture that position. In sum, we see rent-seeking costs as a potential problem for unregulated privatization, but not necessarily a decisive problem. A comparative analysis also must consider the rent-seeking costs involved with various forms of government ownership and regulation. These costs may be quite high, given the profits at stake.

Government Precommitment

The imperfect ability of governments to precommit provides perhaps the most serious problem for the unregulated privatization of water. By construction of our policy proposal, water companies and customers are free to set whatever prices and quantities they can agree to. The analysis so far has simply assumed that governments would honor and enforce these contracts with credibility. In reality, governments often do a poor job of enforcing contracts. Many governments are too incompetent to enforce contracts efficiently, or political pressures intervene and the government deliberately voids or rewrites certain contracts. Even in developed countries governmental interference into the contracting process is common. In the context of an unregulated water market, we can imagine the government rewriting a contract where buyers promise to pay high prices in return for an expansion of capacity or additional hook-ups. Once the hook-ups have been made, political pressures might induce the government to regulate or cap prices. Knowing this in advance, the water company might be reluctant to conclude certain kinds of contracts with potential water buyers. In particular, they will be reluctant to conclude contracts that require them to sink significant amounts of capital. (The water sector typically is the most capital intensive of the infrastructure sectors.) The absence of government credibility will limit the gains from trade.

To a considerable degree, imperfect government credibility simply mimics or recreates the costs of regulation. The costs of forthcoming regulation resemble the costs of having regulation now. In this regard the initially unregulated alternative should not produce inferior performance, compared to regulation. In some cases, however, the initial absence of regulation may create more risks for companies than if regulation were already in place. If a water company knows that future regulation is forthcoming in any case, the company may prefer to know the nature and extent of regulation upfront. Transactions costs

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may be lower if regulation is present from the onset. Although we regard this problem as a serious one, we do not see regulatory risk as a decisive argument against unregulated privatization. First, an initially unregulated system will not necessarily imply more regulatory risk than a system with initial regulation. Even when initial regulation is present, the water company and its customers always face the risk of additional regulation. A non-credible government cannot make policy risk disappear or even diminish by instituting regulations today. In fact the appearance of regulation may be a signal that more regulation is forthcoming in the future. Typically we expect greater credibility from governments which are willing to experiment with market solutions, even if those governments cannot precommit in absolute terms. Today's world exhibits a significant positive correlation between a government's willingness to allow the private sector to operate and the credibility of that government. Starting with a laissez-faire experiment may increase rather than decrease a government's credibility, as it has in Singapore, New Zealand, Chile, and other countries in a variety of (non-water) contexts. Experimenting with unregulated privatization thus might lower regulatory risk, rather than increase it.

The regulatory risk argument also proves too much. We could, for similar reasons, argue that the government should regulate every economic sector immediately, to reduce the uncertainty about subsequent regulation. Yet successful economies do not typically approach regulation in this fashion. Rather, a responsible government first attempts to discover what a good policy might be and then implements that policy. It should not shy away from good policies for fear that the policy might later be abandoned.

Furthermore, a policy "proposal" is precisely that—a proposal about what would work, not a prediction about what will be adopted. Governments might be unwilling to embrace credible commitments to favorable policies, but policy analysts nonetheless should continue to hold such commitments as an ideal or aspiration (Philbrook 1953). Credibility is, in part, a function of what a government, its citizens, and its advisors believe. By attempting to persuade and to change beliefs about what will work, policy analysts themselves manufacture credibility for policies. To argue that a policy will not have credibility is to assume what is at stake in the policy debate itself.

Conclusion

The need for water policy reform is pressing, given the stakes in terms of economic development and human health. The lack or very high cost of access by the poor to safe sources of water has devastating

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social and economic consequences. We have considered unregulated, privatized monopoly as a potential policy improvement. Under some conditions, this policy can approximate a first-best solution across the quantity and quality of output. While we do not expect this first-best result to hold, laissez-faire in water may nonetheless result in a significant increase in the number of water hook-ups. Given the number of individuals who have no access to clean, safe water, this factor should weigh heavily in our evaluation of the policy. The unregulated natural monopoly will bring problems of partial exclusion, bargaining costs, rent-seeking costs, and imperfect government credibility, but in comparative terms we do not see a knock-down argument against unregulated private provision in this context. Unregulated privatization should join the roster of plausible policy alternatives for the water sector.

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Harmonizing Ethnic Claims in Africa: A Proposal for Ethnic-Based Federalism

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Most African states are unitary with political power vested in the central government. Laws and decisions concerning the public sector are enacted and enforced by the central government.[1] Authority is delegated to junior government officials who implement policies within rigid guidelines. Provincial and district levels of government serve administrative roles but do not make laws, collect taxes, or make spending decisions.[2] Strictly speaking, political power is centrally concentrated with heads of states holding the power over all public policies affecting the polity. In most African states, no constitutional limitations constrain the central authority in its exercise of power over public activities at all levels.

The unitary states of Africa largely reflect the colonial legacy. European colonial powers subdivided the African continent among themselves, establishing boundaries that arbitrarily linked heterogeneous

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[1]Cameroon, Nigeria, and South Africa have federal systems of government. Those states, nevertheless, have been characterized by a high concentration of decisionmaking authority. In Cameroon and Nigeria, dictatorial governments have not maintained the federal principle. Until recently, South Africa excluded a large number of its population from participating in the political process.

[2]Local governments in Africa do make some decisions, primarily those that deal with the provision of local public goods. Nonetheless, the powers of local governments are very limited, and in most cases the local governments are under the strict supervision of a government ministry. Thus, local governments are independent only to a rather limited degree. Their lawmaking powers are minimal. In fact, the central government can dissolve a local government at will. That was the case in Kenya during the 1980s when the Nairobi City Council, composed of elected councilors, was dissolved and replaced by a City Commission whose members were appointed by the central government.

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groups in one country and separated otherwise homogeneous, or closely related populations, in another. After independence, charismatic leaders, frequently those who had led the nations during the struggles for independence, forcefully argued for unitary governments much like the colonial governments they replaced. Concentration of power was considered a necessary condition to maintain unity. In fact, even decentralization within unitary states has been considered a political risk because it could reinforce tribal loyalty at the expense of loyalty to the nation.

Nonetheless, the presumed benefits of unitary governments have proved illusionary. In virtually all the countries, post independence has been marked by internal strife, military coups, and civil wars. Conflicts have generally been between heterogeneous population groups within the country. Thus, although an argument for establishing centralized unitary states was that such institutional arrangements would help unify the various ethnic groups, the African experience with unitary states has been disappointing. The experiment with unitary states shows that such institutional arrangements are not suited to harmonize the interests of heterogeneous groups.

A common explanation for the institutional crisis in Africa is the extreme poverty in that continent. In other words, poverty is seen as the main cause of institutional crisis rather the outcome of institutional failure. However, research using public choice theory provides alternative explanations for political instability, for unwholesome features of political institutions such as bureaucratic corruption, and for dismal economic performance in Africa.[3] Those studies treat tribal groups as special interests that compete for transfers from the central government. Members of a particular tribe consider themselves different from those of other groups and have an interest in increasing the welfare of their members relative to that of other tribes. Because of the concentration of power in unitary states, the leadership can redistribute resources from some tribes to others. Consequently, a tendency exists for tribal groups to compete for the control of the instruments of transfer because such control assures the controlling group a consistent flow of transfers. Tribal competition for control of the instruments of transfer has had disastrous results in many African countries. The ongoing conflicts in Rwanda, Sudan, and Zaire are but a few of the cases where members of one tribe continue to inflict serious atrocities against members of other groups. The competition for political control results in tribal conflicts, military coups, and civil

[3]Brough and Kimenyi (1986), Kimenyi (1987), Kimenyi (1989), and Kimenyi and Mbaku (1993).

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wars. Such outcomes, plus the nonoptimal public policies designed to benefit some groups at the expense of others, translate into poor economic performance. It is therefore difficult to justify the claim that unitary states unite heterogeneous populations.

There is convincing evidence showing that Africa's unitary states do not comprise "optimal units of collective choice." Unifying ethnic groups by decree has resulted in institutions that are not suited to achieving cooperative agreements among the various groups. Instead, more often than not, unitary states associate with Pareto-inferior outcomes whereby competing groups fail to achieve cooperative solutions in prisoner's dilemma situations. Groups in these institutions are therefore trapped in Pareto-inferior noncooperative outcomes. Thus, in essence, highly centralized unitary states have resulted in outcomes that are very much like those found in stateless societies described by Thomas Hobbes ([1651] 1962). It is clear that the observed crises in Africa reflect institutional failures, and for Africans to emerge from this state of affairs, it will be necessary to establish institutions that facilitate the achievement of cooperative solutions in prisoner's dilemma situations.

This paper advances the idea that the most pressing institutional problems confronting Africans have to do with the internal organization of their states. Specifically, African countries do not use political arrangements that are suited to solving prisoner's dilemma problems. The paper argues that to harmonize conflicting interests of various ethnic groups, countries characterized by high degrees of ethnic diversity should adopt institutional arrangements that utilize ethnic units as a basis for local governments. The analysis presented here suggests that because members of each ethnic group consider themselves different from members of other groups, establishment of ethnic government units that possess a fair degree of autonomy would be the most desirable form of organizing African societies. Since ethnic groups associate with particular territories, African states are naturally suited for the establishment of federal systems of government.[4]

The paper proceeds as follows: First a brief history of African countries and their institutions is discussed. Ethnicity and its implications for the organization of African societies are then examined. Ethnic groups are viewed as being analogous to voluntary clubs that perform some desirable functions for the members. It is demonstrated that ethnic groups may be best suited to provide some "local" public

[4]In some countries, different ethnic groups live in the same regions and no group can claim exclusive ownership rights. The case of Hutu and Tutsi in Burundi and Rwanda is a good example of a country where two rival groups share territory.

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goods and therefore ethnicity could be used to define local jurisdictions in a federal system. The paper then outlines some features of African institutions that make federalism desirable followed by some concluding remarks.

Colonial Rule and the Creation of the African State

Institutions of collective choice emerge as solutions to minimize transaction costs of achieving cooperative agreements. Such agreements are necessary for Pareto optimality in presence of public goods and externalities. Absent a government, the independent self-interested actions of each member of society translate into outcomes that are Pareto-inferior. This result is demonstrated by the classic prisoner's dilemma matrix as shown in Table 1. The matrix shows the payoffs to two tribal groups who are in a conflict situation. Tribe members can either live peacefully or steal from each other. The payoff matrix shows that both tribal groups are better off if they live peacefully (cell #1) instead of stealing from one another (cell #4). However, each tribal group would be better off if it succeeded in stealing from the other (cell #2 and #3) as long as the other decided to live peacefully. The situation shown in the matrix represents a dilemma because the "steal" strategy dominates the "live peacefully" strategy. In absence of cooperative agreements, the tribal groups are worse off than if they entered into such agreements. Once the tribal groups recognize this dilemma, it is in their best interest to reach agreement and achieve the cooperative solution (cell #1).[5]

TABLE 1

TRIBAL GROUP'S DILEMMA

Group 1	Group 2	
	Live Peacefully	Steal
Live Peacefully	#1 (300, 300)	#3 (0, 400)
Steal	#2 (400, 0)	#4 (30, 30)

[5]Here we treat the tribal group as the decisionmaking unit. This is realistic in the African context, and conflicts that we focus on primarily involve different tribal groups.

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As noted, African countries are characterized by dictatorial political systems, serious internal divisions, and civil wars. Those outcomes suggest that institutional arrangements in Africa are not effective in solving prisoner's dilemma problems and are unable to facilitate the achievement of cooperative solutions. While many countries are attempting to establish constitutional democracies, there seems to be little hope that such efforts will result in a resolution to the current crisis in that continent. To understand why institutional arrangements in Africa fail to facilitate the achievement of cooperative agreements, and why merely writing new constitutions without radical transformation of the institutions may be futile, it is necessary to look at the origin of the present day African states and their institutional arrangements.

The emergence of the modern African state is largely the result of a number of events that disrupted the traditional African way of life. The most important of these include the African slave trade, the spread of Islam, and the imposition of colonial rule. The people of North Africa, for example, readily accepted Islam and governmental institutions introduced by Arabs. Islam also had some influence on people living along the East African Coast. The slave trade on the other hand provided a lucrative source of wealth to Arabs, Europeans, and African Kingdoms that were involved in the trade. The slave trade also created a variety of conflict situations as slave raids spread from the coast to the interior regions of Africa and guns were introduced into African states as payment for slaves. Those events disrupted the organization of traditional societies but did not have significant lasting effects on the basic institutions of most of sub-Saharan Africa.

Probably the most important event that explains contemporary African institutions is European colonialism. During the late 1800s, Great Britain, France, Germany, Belgium, and to a lesser extent Italy and Spain, were heavily engaged in attempts to place under their control parts of the African continent—what is known as the "scramble for Africa." Between 1870 and 1880, the European powers rapidly expanded their territorial claims and as each power acquired more and more of the continent, it became apparent that competition for Africa threatened peace in Europe. In 1884, Chancellor Otto Von Bismarck of Prussia invited European nations for a conference in Berlin with the main goal of regularizing the scramble for Africa. The Berlin Act of February 26, 1885, stipulated how Africa would be partitioned into European colonies. By 1910, the partition of Africa was achieved and, for the next 45 years, only Liberia and Ethiopia (which was occupied briefly by Italy) remained independent nations (Burke 1991).

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Colonial rule adversely affected African institutions. Indeed, many of the problematic features of current African political institutions are the product of the colonial experience (Mbaku and Kimenyi 1995).[6] Most important, in partitioning Africa among themselves across *spheres of influence,* colonial powers rarely took into consideration the issue of ethnic heterogeneity. In some countries, the boundaries were drawn in a manner that separated members of the same ethnic group by placing them in different countries while at the same time placing other, formerly separate groups in the same country. Partition was implemented without due regard to ethnicity, culture, or even the existing institutions of government. The various groups did not participate in deciding which other groups to unite with nor did they have an opportunity to agree on the nature of their relationship with these other groups. In the process, different ethnic groups were placed within the same authority and confined within the same boundaries. In other cases, members of one tribe were dispersed among different nations. Likewise, colonial partition disrupted long established kingdoms and tribal governments, and also disrupted existing trade networks and other inter-ethnic linkages. Thus, the political units that were created by Europeans were not only arbitrary but also lacked any strong unifying factors.[7]

At the time of independence, the new nations had to make crucial decisions concerning the constitutional dimensions of government activities. These dimensions included such characteristics as the number of jurisdictional levels, whether the political system was to be unitary with power concentrated at one level, or federal system with power distributed between regional governments and a central government. In the case of the federal system, decisions had to be made concerning the number of levels, such as provincial, district, municipal, and local, and also the functions that would be performed at each level. Other decisions pertained to procedures and processes of selecting representatives, and the constitutional rules regulating the amendment of the constitution.

In selecting particular constitutional dimensions, the primary objectives included the achievement of both economic growth and a just and free society that provided freedom from oppression of one group by another. The leaders, at least ostensibly, sought to adopt constitutions that would advance individual liberty.

[6]For a recent discussion, see Kimenyi (1997a).

[7]This is particularly true for countries in sub-Saharan Africa. This paper primarily focuses on this part of the continent or what is referred to as Black Africa.

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Concerned by the fact that the various tribal, religious, and linguistic groups in each of the countries considered themselves different from other groups in various respects, the issue of unity was a primary concern. Specifically, unifying the groups into one national state was considered crucial for political stability. To be sure, Africans had to deal with pressing problems of unity after independence that may have required them to adopt unifying policies. For example, many tribal communities existed independently. These communities frequently consisted of thousands of members and possessed well-developed cultures and languages and clear tribal consciousness.

However, the existing national boundaries cut across those groups ignoring the boundaries that defined previously autonomous units. For this reason, leaders advocated the establishment of unitary states with a high concentration of power. It was claimed that centralizing power allowed for the adoption of uniform policies and for the balancing of economic resources, thus uniting diverse populations.

Some leaders argued that single-party political systems were more appropriate for African countries because all groups (tribal, religious, linguistic), regardless of their differences, would be joined together under one party. Thus, the single-party system was seen as an important unifying agent of otherwise different groups. The leaders warned that unity would be sacrificed if political party competition were to be introduced because different political parties would be dominated by particular tribal and linguistic groups, which in essence would promote tribalism (Winchester 1986). Thus, the common response to diversity was the adoption of policies and institutional arrangements that unified heterogeneous populations by limiting expressions of group preferences.[8]

Unfortunately, attempts to unify ethnic groups in Africa have largely been unsuccessful as evidenced by various ethnic rivalries that have resulted in continuous civil wars in the continent and the domination of some ethnic groups by others. Thus, evidence points to the fact that institutions of the sub-Saharan African countries are not adequate to deal with the high degree of population heterogeneity. Institutional arrangements that have sought to unify ethnic groups by denying them autonomy have not been successful in achieving cooperative agreements among the ethnic groups. These arrangements create situations whereby ethnic groups are trapped in a Pareto-inferior "steal-steal" strategy. It appears that units of collective choice that

[8]Until the recent democratization movements in Africa that took hold during the late 1980s, most states outlawed political party competition. Even in those that permitted entry of other parties into the political markets, the party activities were largely restricted.

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seek to unify various ethnic groups are not optimal and therefore do not minimize the transactions costs of achieving cooperative agreements. It is contended here that for units of collective choice to minimize the costs of arriving at cooperative agreements, they must to some degree be based on ethnicity.

Ethnic Clubs and Units of Collective Choice

To appreciate the significance of ethnicity in the organization of African societies, it helps to note a number of features relating to ethnic composition of those countries. The first of these is that sub-Saharan Africa is ethnically very complex. In total, there are over 2,000 distinct tribes or ethnic societies, each of which has its own language or dialect, culture, and tradition (Ayittey 1992). These tribes vary in size, with some having as few as 100,000 members and others encompassing millions of people. The degree of ethnic heterogeneity varies widely across the countries. In Rwanda and Burundi, for example, there are only two primary ethnic groups and two languages. In Sudan on the other hand, there are over 170 distinct languages. In Nigeria, there are between 200 and 400 distinct linguistic groups, and in Zaire, there are about 250 ethnic groups.

The other notable feature is that Africans show a high degree of tribal identification. By and large, identifying with one's tribe is highly valued. As such, resources are devoted to make certain that members of a group continue to identify with that group. In virtually all African communities, children are taught from a very young age that they should identify and be proud of their tribe. Thus, children learn at early ages that it is honorable to vote for members of their tribe or region, and that members of some tribes are not trustworthy and thus they should not do business with them. In some cases, tribe members are warned against associating with members of particular tribes.[9] As stated by Horowitz (1985, p. 7), "in general, ethnic identity is strongly felt, behavior based on ethnicity is normatively sanctioned, and ethnicity is often accompanied by hostility toward outgroups."

In most areas of everyday life, there are many instances in which individuals identify with members of their own tribe. Thus, even in major cities where people from different tribes live in close proximity, tribal groupings emerge as individuals freely select with whom to associate. Even today, the majority of urban social welfare organizations are organized along tribal lines. Urban soccer leagues are primarily organized along ethnic lines. Strong tribal preference has also been

[9]For example, it is not uncommon to find strong opposition to intertribal marriages.

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revealed in a variety of studies that seek to measure the social or political spatial "distance" between ethnic groups. W. J. Breytenbach (1976: 313), for example, observed that in Zambia, ethnicity played an important role in all types of associations:

> Members of various tribes clustered together on account of their regional and cultural affinities, for instance, western and eastern tribes formed separate clusters due to their particularistic bonds and interests. Those results suggested that ethnic factors played significant roles in formation of voluntary associations among heterogeneous groups, and voluntary associations normally tend to be specifically organized for the pursuit of special interests, be they economic or political, etc.

Likewise, Kenneth Little (1957) has observed that tribal-oriented associations—such as the Ibo State Union, which consisted of village and clan groups—rated among the most important voluntary associations in West Africa. Identifying with one's tribe also dominates in participation in political parties, labor unions, and so on.

The other important feature of African societies in regard to ethnic groups is that in most cases, each group associates with a particular territory. Although the boundaries that demarcate ethnic territories are not always clearly specified, they do nevertheless exist and to a large extent they are respected by the respective groups that live next to each other.[10] Thus the various ethnic groups have what they refer to as their territory and, in many respects, members of other ethnic groups are considered as outsiders. Thus, by and large, ethnic units do make up what could be called "ethnic nations."

It is well known that the most preferred choices are realized when an individual decisionmaker has maximum independence. In the real world, however, individuals have to associate with others for particular matters. The more people involved in the decisionmaking process, the less likely that an individual's preferred choice will be selected. With more and more heterogeneous preferences, the outcomes differ markedly from each person's preferred choice. Because tribes are composed of people who, as a result of their past experiences, family ties, and aspirations, have preferences that are closely related on a variety of matters, decisions that are made by the tribal units are likely to be more representative of individual preferences than would result when many tribes are involved. Thus, tribal organizational units are

[10]Some of the ethnic conflicts that have continued for many years are frequently due to disputes concerning the ethnic territorial boundaries. In other words, they are the result of "poorly" defined ethnic property rights. In most cases, however, the "ethnic" property rights are well defined.

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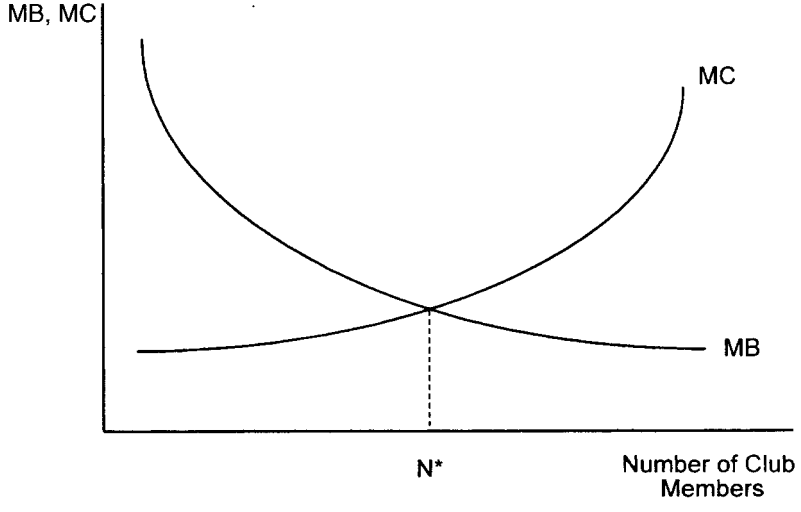
in some respects analogous to voluntary clubs that are composed of people whose preferences are fairly similar.

The efficiency results of voluntary organizations such as clubs are well known and have been discussed extensively in the economic literature. James Buchanan (1965) was among the first to explore the efficiency properties of voluntary clubs. The economic model of clubs presented by Buchanan assumes a situation where individuals have identical tastes for both public and private goods. The optimal size of a club is determined by the marginal benefits and marginal costs. Figure 1 shows the marginal benefit (MB) and marginal cost (MC) from an additional member as seen by other members. The marginal benefit represents costs savings from adding new members because fixed costs are spread among more people. Additional benefits decline as club size increases. On the other hand, marginal costs increase as club size increases. The rising marginal costs reflect increasing costs due to congestion. The optimal club size (N*) is one where the marginal benefit club members receive from adding another member equals the additional costs associated with the new member.

Central to the efficient results of voluntary clubs are conditions of entry and exit. A member of a club who does not like a particular club's policies is free to exit and to join clubs that better represent his or her preferences. Although such exit involves costs, individuals make decisions by comparing the benefits of exit with the costs. If

FIGURE 1

OPTIMAL CLUB SIZE



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expected benefits exceed the costs of exit, then the individual exits. It is this mobility property of voluntary organizations that guarantees that an individual's preferences are served even in a group setting. The freedom to select those organizations that best serve one's preferences suggests that voluntary clubs and organizations advance individual liberty.

What about the tribe? Unlike voluntary organizations, entry into a particular tribe, other than the one into which a person is born, is not possible. Likewise, exit from one's tribe is practically impossible. While limits to entry and exit may appear to undermine efficiency, I suggest that "partial" exit and "partial" entry are possible and serve the same goals that entry and exit serve in voluntary organizations.

Individuals can select the degree to which they identify with a particular tribe. This opportunity of selective identification allows persons the liberty to associate with members of their tribe on some matters and to disassociate from members of their tribe on other matters and instead to associate with members of other tribes. Thus, on the one hand, the tribe can be viewed as an involuntary association because of entry and exit barriers. On the other hand, identifying with a tribe is voluntary because one can choose the degree to which one identifies with one's own or any other tribe.

The fact that we observe strong tribal identification in Africa should be considered a largely voluntary choice by the individuals concerned. From an economic perspective, the expected benefits of identifying with one's tribal group exceed the costs of such identification.[11] When members of a tribe live and organize their activities without interfering with members of other tribes, then the tribal unit is an optimal form of organizing for the purpose of providing some goods and services to its members. In this respect, the tribal unit is analogous to a private club that serves the interests of its members.

Jennifer Roback (1991) notes that one of the beneficial tasks performed by ethnic groups is that of assisting the teaching and enforcement of social norms and behavior. Given the prisoner's dilemma situations that face individuals in making collective choices, individual members of society have an incentive to cheat because such behavior

[11]Kimenyi (1997b) presents a model of tribal identification that shows how voluntary integration arises. In this model, the demand for identifying with one's tribe is shown by a downward sloping marginal benefit curve while the supply is an upward marginal cost curve of tribal identification. In other words, as individuals identify more and more with members of their tribe, additional benefits fall and additional costs rise. The intersection of the marginal benefit and marginal cost of tribal identification determines the activities that ethnic groups should keep to themselves and the matters that they should organize with members of other tribes.

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is profitable. However, if everybody cheats on every occasion on which they expect to profit, then everybody in society faces the worst possible outcome. Because people have a long-term attachment to their groups (for example, through blood or past memories), they are more likely to have continuous dealings with members of their ethnic group than with members of other ethnic groups. Continuous dealing reduces cheating in prisoner's dilemma situations and as a result ethnic groups may be more efficient in the provision of public goods than the state. Roback (1991: 63) observes:

> Ethnic attachments can provide significant substitute for contract law. That is, members of ethnic groups that have substantial continuous dealings with each other can develop norms of cooperation, promise-keeping and honesty. . . . Thus ethnic groups can provide alternatives to government in the provision of certain public goods such as the enforcement of social norms, and in the solution of prisoner's dilemma problems. In fact, ethnic groups and other groups smaller than the modern state may actually be more efficient providers of these kinds of goods.

Benefits to members also arise from the tribal organization of production of goods and services. A tribe may possess its own production technology and its own unique division of labor. Members of the tribe learn different types of production skills and work habits. Thus, in addition to the production of valuable social norms, the tribal organizational unit plays a significant part in organizing the production of goods and services. Ethnic groups also provide other services such as social insurance and entertainment and act as sources of collegiality and pride (Congleton 1992).

The club model discussed above is extended to show why organizing along tribal lines may be efficient. If members of the same ethnic group organize particular activities such as the provision of local public goods, then the optimal ethnic club size would be at the point where MB = MC, as shown in Figure 1. The assumption is that members of ethnic groups have fairly close, though not identical, tastes.

Inclusion of members from other ethnic groups affects the optimal size of ethnic clubs in two ways. The first of these is that adding members from other tribes creates a kink in the marginal cost curve (Figure 2). The cost rises because of difficulties in communicating across ethnic and linguistic boundaries. The second result of adding members from other ethnic groups is to create a kink in the marginal benefit curve at the boundary of the ethnic group (Figure 3). This reflects the discontinuity in the group norms, which do not extend beyond the group (Landa 1994).

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FIGURE 2

OPTIMAL ETHNIC CLUB SIZE: KINKED MARGINAL COST

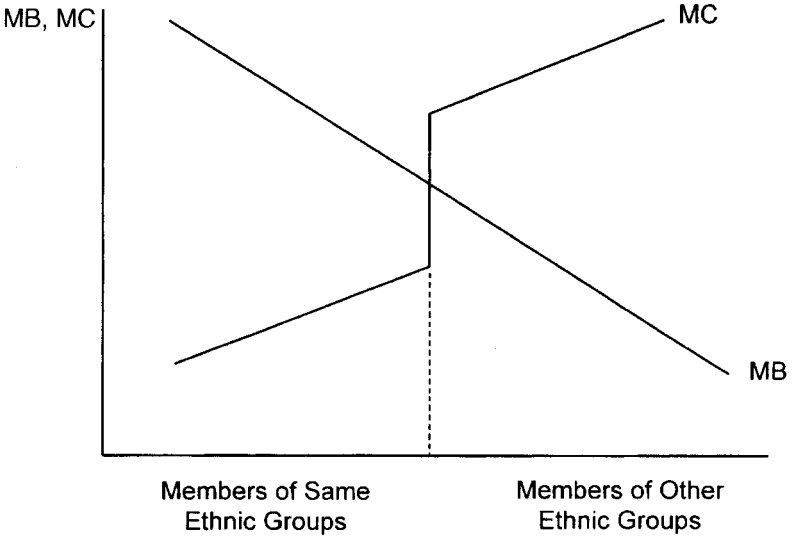
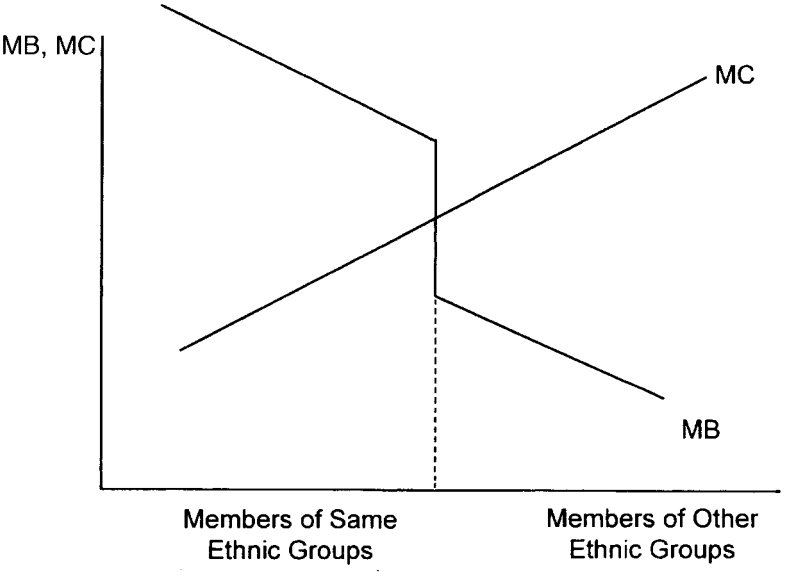


FIGURE 3

OPTIMAL ETHNIC CLUB SIZE: KINKED MARGINAL BENEFIT



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Because of discontinuities in marginal benefit and marginal costs that result from adding members from other ethnic groups, the boundary of the club is marked off by members of one's own ethnic group.[12] Given that African tribes associate with clearly identifiable territorial boundaries (what is referred to as geoethnicity), then ethnic groups do form a natural basis for defining units of collective choice. Such ethnic units of collective choice are better suited to provide some local public goods. Because of the fact that members of the same ethnic group are engaged in continuous dealings, ethnic-based governments would be better at solving prisoner's dilemma problems. This then suggests that ethnicity must be taken into account in determining the optimal local jurisdictions.

So far, tribal units have been considered analogous to voluntary clubs that are compatible with efficient outcomes. However, even voluntary clubs have problems in enforcing compliance. Mancur Olson (1965) has attacked the orthodox view that voluntary associations are always efficient in the provision of collective goods and has specifically challenged the view that the effective participation in voluntary associations is virtually universal. Because voluntary associations organize around collective goals, it is often not rational for an individual member to pay for such a goal. Instead, members may pursue their interests by free-riding on other peoples' efforts.

We therefore expect ethnic-based provision of collective goods and services to be undermined by free-riding. As such, members cannot be expected to pay their share voluntarily without some form of organized authority to enforce compliance. Because widespread free-riding lowers the well-being of all members of the ethnic group, everybody benefits when an ethnic government is established. Notice that such a government is analogous to a club management team that enforces payments of fees and dues and oversees that club rules are followed. The free-rider problem is likely to be less prevalent when the group is made up of one ethnic group than when several ethnic groups are involved.[13]

[12]We could envision marginal benefits and marginal costs when families, extended families, and clans organize some activities. The marginal benefit and marginal cost curves would have kinks as one moves from organizing activities from family to extended family. Likewise, including members of other clans would be marked by kinks in the benefit and cost curves. This shows why some activities are best left to the family, extended family, or clan and not the entire tribe. This may explain the rivalry of clans in Somalia.

[13]A proposal for the establishment of ethnic governments may be considered radical. However, evidence from the history of African societies shows that such ethnic-based governmental units functioned quite well and had many features of representative governments. See for example, Ayittey (1991), Mair (1965), and Vaughan (1986).

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Some ethnic groups may be so large that even an ethnic government may not be efficient in preventing free-riding. In this case, the population exceeds the optimal club size. Organizing around such an ethnic group is not efficient and in such cases it may be necessary to set up a number of competing governmental units that can monitor free-riding more efficiently. In addition to minimizing free-rider problems, such competing governments open up opportunities for "voting with the feet" because members have several choices of tribal jurisdictions.

Ethnic tribal units have other limitations that relate to their sizes. Ethnic units may be too large for organizing some activities. Some goods and services require smaller political units. For example, provision of primary school education could be more efficiently organized by the village. Just as, in some cases, individuals organize along tribal lines, at other times they may organize into villages. As a matter of fact, the history of African communities reveals an elaborate division of activities not only by ethnic units, but also by villages and clans.

Ethnic units could also be too small to organize for the provision of some goods and services. For example, it is unlikely that ethnic groups can efficiently organize for the provision of university education. In such cases, it is necessary for different ethnic units to form political associations for the purposes of accomplishing these tasks. Notice, however, that such associations take the form of market exchange—they are voluntary and thus benefit ethnic groups that enter into such associations. It is also the case that the rules that establish the relationships between such ethnic groups must be reached by agreement. Beneficial political associations will tend to be durable while those that do not benefit all the groups involved will tend to be unstable. The key then is that any form of integration should be by consent.[14]

The discussion above leads us to a similar conclusion to that reached by W. A. Lewis (1965) over three decades ago who noted that the new African governments' attempts to suppress tribal loyalties was a futile exercise. Lewis (p. 68) instead suggested the use of such loyalties as a base for establishing institutions that permitted self-expression by all tribes:

> Any idea that one can make different peoples into a nation by suppressing the religious or tribal or regional or other affiliations to which they themselves attach the highest political significance is simply a nonstarter. National loyalty cannot immediately supplant

[14]This is similar to the analysis advanced by Buchanan and Tullock (1962) of mutually beneficial political exchange.

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> tribal loyalty; it has to be built on top of tribal loyalty by creating a system in which all the tribes feel that there is room for self-expression.

The primary argument advanced here is that African governments' refusal to permit ethnic groups to organize for the provision of public goods and services has resulted in the creation of units of collective choice that are not suited to achieving cooperative agreements. There are numerous advantages in relying upon the "tribe" as a basis for organizing governments in Africa. For one, tribal territories provide natural boundaries that can define stable political jurisdictions. In addition, there are various factors that unite members of a tribe that facilitate solving prisoner's dilemma problems such that cooperative outcomes are achieved. Consequently, there is a strong case for defining boundaries of local units along ethnic lines. For such units to be efficient in meeting the preferences of their populations, they must posses a fair degree of autonomy. However, it must also be recognized that various groups must necessarily associate on some matters. In essence, the ideal institutional arrangement that would preserve ethnic autonomy and yet permit ethnic groups to be united for some purposes is a federal arrangement.

Conditions Favoring Federalism in Africa

Federal governments are fairly common and to a large extent function smoothly. Examples of federal governments include Australia, Canada, Germany, Switzerland, and the United States of America. The key characteristic of a federal system of government is the association of states or regions in which member states or regions retain a large measure of independence. Federal governments adhere to the federal principle: *The method of dividing powers so that the general and regional governments are each within a sphere, coordinate and independent.*[15]

The proposed federalist option for African countries would be one where ethnic groups in various regions would establish their own regional governments. Each region would be independent in some spheres, which would be clearly stipulated in the federal constitution. These regions would then have elected representatives to the federal legislature as is the case with other federal governments. However,

[15]See Wheare (1947). For detailed discussion of the federal principle, see Lemco (1991) and MacMahon (1962).

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for African countries, emphasis is placed on how the local jurisdictions are drawn.[16]

There are many advantages of establishing federal systems of government in Africa. Federal systems permit policy experimentation and also facilitate the achievement of efficient outcomes due to interjurisdictional competition.[17] However, the primary advantage of establishing federalist institutions in Africa is that such is the only system of organizing collective activities that protects groups from oppression by others and also accommodates diversity. These outcomes reflect the fact that in a federal system power is decentralized and neither the general nor regional governments possess absolute power.[18]

In the unitary states of Africa, the central governments are frequently dominated by members of some group, race, tribe, or religion. As a result, chances are that in countries where there are heterogeneous groups, as is typical in Africa, some groups will be excluded from the ruling coalition. Given the unlimited powers to coerce possessed by unitary states, those governments often adopt discriminatory policies that oppress groups that are outside the ruling coalition. A federal system, with the guarantees afforded to regions in regard to their independence and the fact that the general government has limited powers, offers protection to all groups in the country.

Even ethnic groups in the same countries tend to have significantly different social institutions. A main source of dissatisfaction by ethnic groups in Africa is that, more often than not, the policies adopted by the unitary governments fail to accommodate groups with widely varying preferences, customs, and norms. By attempting to unify otherwise diverse groups, unitary states fail to accommodate some groups. Thus, establishment of regional governments that possess a fair degree of autonomy allows individual groups to preserve their identity.

In additional to these benefits, several conditions exist in Africa that point to the appropriateness of federal systems of government. The high degree of ethnic heterogeneity in that continent and the fact that ethnic groups associate with particular territory have already

[16]A major issue in federal systems of governments is the allocation of functions between regional and the federal governments. We do not go into such details here. However, a well-functioning federal system is one that is highly decentralized so that most collective activity is left to the lower levels of government.

[17]For a comprehensive treatment of the advantages of federal systems of government, see Breton (1980).

[18]The powers and responsibilities of federal governments vary. But, in general, they are clearly specified. The boundary of what the federal government should do must be clearly specified. The distribution of powers between regional and federal governments is crucial to the smooth functioning of the federal union.

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been noted. Both of these features present natural conditions for a federal system. In addition, religious heterogeneity is important in some countries. Nigeria and Sudan are good examples of countries where religious groups have clearly expressed their desire for autonomy. More often than not, leaders of unitary states establish policies that are clearly unsuitable to some groups. This is the primary reason why Christians in the south of Sudan have sought autonomy from the Muslim north. Such differences can be accommodated by establishing a federal system.

Another feature of African countries that would make federalism desirable is the geographical isolation of some communities. Even in an otherwise homogeneous nation, isolated communities develop distinct regional consciousness. Such consciousness makes the communities want to keep to themselves. When different communities in the same country develop such distinct regional awareness, they may all need to secure some degree of independence while uniting for some purposes.[19] Furthermore, when communities are isolated from the rest of the country in a unitary state, they may rightfully feel that the central government is too remote from them and fails to serve them as well as it does other communities.

Another factor that favors the establishment of federalist institutions in Africa is the size of the nations. Some of the countries are very large in terms of population and area. Nigeria has more than 100 million people, Ethiopia has a population of 54 million and Sudan has a population of 28 million. The geographical size of Sudan is one-third that of the entire United States; Ethiopia is twice the size of Texas; Mozambique is twice the size of California, and Chad, with a population of only 5.2 million is three times the size of California.[20] Somalia, which is relatively small compared with other African countries, is the size of Texas. Clearly, some of the African countries are excessively large, which makes it difficult for governments to serve local communities effectively.

Finally, many regions and communities in Africa had, at some time in the past, their own governments. Prior existence of "tribal" kingdoms, or chieftainships, means that there are already strong ties

[19]Such geographical isolation of communities played an important role in the creation of a federal system in Switzerland. Switzerland has a very rugged topography where mountains and valleys create small, isolated communities that are distinct and that have developed some degree of independence.

[20]Recently, some researchers have advanced the argument that the African states are themselves not optimal. In fact, this author believes that the map of Africa will radically change as democratic institutions mature and groups freely express their self-determination goals (Kimenyi 1997c, 1997d).

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that hold people in a particular region or community together. Furthermore, the fact that a government existed in the past implies that groups may want to regain their independence that they had before the formation of the unitary state. This has been evident in countries like Uganda, where previous kingdoms have continued to press for autonomy from the central government.

Conclusion

At the core of the analysis presented in this paper has been the relationship between ethnic heterogeneity and the costs and benefits of organizing collective activity. It has been suggested that ethnicity is an important feature of African countries and one that economizes on organizational costs. This suggests that the provision of public goods along ethnic lines has distinct efficiency characteristics. In particular, ethnic-based institutions have a comparative advantage in solving prisoner's dilemma problems.

A primary implication of the analysis is that the optimal institutional arrangement in nations characterized with high degrees of ethnic diversity is one that allows for the establishment of local "ethnic" jurisdictions. Each of those jurisdictions should possess a fair degree of autonomy. Naturally, this suggests the establishment of multilevel governments. Thus, it appears that the most immediate institutional reform for Africa should be the establishment of federal systems of government.

Popularizing federalism with Africans is a challenging task. Federalist proposals have been criticized by incumbent African leaders on the basis that such systems of government reinforce tribalism. The benefits associated with organizing along ethnic lines notwithstanding, the proposal outlined in this paper recommending the use of geoethnicity in determining appropriate regional units of collective choice is likely to be challenged as a form of "apartheid." For federalism to be accepted as an ideal method of organizing society, it is necessary to emphasize the suitability of such a system particularly in creating a harmonious society.

Nonetheless, with the new democratization movements in Africa, there are signs of change. As a matter of fact, discussions by politicians and academics about the viability of federalism are going on in various countries. In Kenya, for example, a debate has emerged that focuses on proposals to change the current institutional arrangements and instead establish a federal system with provincial governments. Likewise, Ethiopia recently adopted a constitution that provides ethnic groups with a large measure of autonomy.

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The federalist proposal presented in this paper relies heavily on the fact that ethnic groups associate with specific territory and therefore calls for territorial federalism. However, territorial federalism may not solve some of the most serious ethnic rivalries in Africa. A good example is the case of the Hutu and Tusti in Rwanda and Burundi. These two groups share the same territories and no group has exclusive rights to a specific region. Territorial federalism is therefore not feasible in these countries.[21]

A possible solution to the ethnic rivalries in Rwanda and Burundi may lie in the nonterritorial federalism proposed by Gordon Tullock (1994). Nonterritorial federalism involves the establishment of competing governments in the same territory, and individuals have the option of selecting which governments to belong to. Such governments operate much like private clubs, so an individual could belong to various such governments. Thus, individuals residing in the same neighborhoods could actually belong to different nonterritorial states. While nonterritorial federalism has some distinct advantages in dealing with ethnic conflicts, it is nevertheless a complicated institutional arrangement and not necessarily efficient from the standpoint of resource allocation. However, given the high costs associated with ethnic conflict in countries such as Rwanda and Burundi, nonterritorial federalism should be given serious consideration.

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[21]The Hutu-Tutsi problem is complex and may require quite complex solutions. Suggestions for dealing with the ethnic rivalries in these countries have included radical proposals such as designating one country for the Hutus and the other for the Tutsis. Other proposals have called for incorporating these countries into neighboring countries.

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The Unintended Consequences of Trade Adjustment Assistance

Cecil E. Bohanon and Marilyn Flowers

Government programs designed to compensate workers and firms harmed by increased import competition often accompany trade liberalization. In the United States, the Trade Adjustment Assistance Act of 1974 offers such compensation to workers. Additional legislation designed to compensate displaced workers was adopted following the North American Free Trade Agreement of 1994. Such trade adjustment assistance (TAA) is considered a pragmatic and normatively appealing way to offset political resistance to trade liberalization. Economist Jeffrey Schott of the Institute for International Economics stated, "Assistance programs [were] incorporated into NAFTA legislation to buy some support and to alleviate some of the dire concerns of NAFTA critics" (quoted in Richards 1997: A1). Economists have generally approved of such compensation schemes (see, for example, Bergsten 1997: 26; Bhagwati 1982: 168, 1994: 21–22; Eisner 1997:A22; Feenstra and Bhagwati 1982: 246; and Lawrence and Litan 1986: 27).

Although there are a number of TAA programs, they are typically offered to workers who lose their jobs as a result of foreign competition. Workers who believe their job loss is attributable to such competition first file a petition with the governor of the state in which their employment is located. The governor's office then forwards an initial recommendation to the secretary of labor, who ultimately determines the case. If it is certified by the secretary that the job loss is attributable to foreign competition, the workers become eligible for a variety of benefits.

Those benefits can include an extension of unemployment compensation for up to a year, if the worker is in a training program; the

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payment of worker education and retraining costs; and job search and relocation allowances (U.S. Department of Labor 1998). Total federal expenditures on TAA have been around $350 million annually since 1995 (Executive Office of the President 1996). As of December 1997, over 150,000 workers had been certified under the NAFTA-TAA program alone (Public Citizen 1998). Further discussions of trade liberalization and free-trade agreements will undoubtedly be accompanied by calls for extended and expanded TAA programs.

This paper points out some of the unintended consequences of TAA. First, its implementation almost certainly decreases the gain from trade liberalization and could conceivably reverse it. The reason is simple. Compensation is paid only to those who exit an impacted industry. As a result, forgone compensation becomes part of the opportunity cost of continuing production. TAA therefore gives domestic producers an artificial incentive to exit when pressed with foreign competition. The lure of compensation means that some domestic producers will abandon the industry even though their true production costs are below those of foreign producers. The social loss resulting from this compensation-induced resource misallocation can more than offset the gains from trade liberalization, making liberalization-cum-compensation an economically inefficient policy.

Second, there are some potentially troubling equity implications of the assistance. TAA is targeted at resources that are displaced by foreign competition. This, in turn, implies that those producers who are harmed least by foreign competition receive the most compensation as a percentage of their loss. In contrast, producers who are harmed most by foreign competition either obtain less relative compensation or receive no compensation at all. Ironically, domestic resources that receive no compensation from TAA are those that are most competitive in the presence of international competition.

A Single-Period Numeric Example

A simple one-period numeric example can illustrate these points. Suppose a domestic producer produces 10 tons of coal at an opportunity cost of 525 bushels of corn. Suppose the domestic price of the coal is $250 a ton, while the price of corn is $4 a bushel. The producer realizes $2,500 in income from coal production at an opportunity cost of $2,100 in forgone corn. The producer obtains a $400 gain.

Now suppose a foreign producer offers coal at a price of $225 a ton. The domestic producer will match the price of his competitor and still produce the coal, although his gain declines to $150. His loss

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of $250 is transferred to consumers in the form of a lower price. There is no net loss to the domestic economy.

If, on the other hand, the foreign offer price is below $210, say $150 per ton, the domestic producer will forgo coal production and produce $2,100 worth of corn. The foreign coal supplier's claim on domestic output is $1,500 ($150 × 10). The impact of the import is that the domestic economy has the same amount of coal *and* $2,100 worth of other goods of which foreign producers can only claim $1,500. National welfare, therefore, rises by $600 as a result of the import.

This argument for free trade has been made at least since the time of Adam Smith. Free trade improves domestic welfare because more goods and services are available to domestic consumers. Although import substitution is painful for some, the economy as a whole benefits by substituting lower cost foreign goods for higher cost domestic goods.[1]

But now let us incorporate TAA into the scheme. Suppose the coal producer has a legal entitlement to $25 per displaced ton, or in this example $250, if his exit from the coal business is due to foreign competition.[2] *Although the social value of the coal producer's alternative is still $2,100 worth of corn, the coal producer's private cost of coal production is $2,350 when faced with foreign competition.* A $225 offer price of coal from a foreign producer will induce the domestic producer to abandon the coal industry. The economy, in this case, obtains the 10 tons of coal from the foreign source and $2,100 worth of corn from the domestic producer. However, the foreign producer's claim on domestic output is $2,250. The domestic economy is worse off by $150 because of the import. Higher cost foreign coal has substituted for lower cost domestic coal, because of the compensation offered to the domestic producer.

To explore the equity implications of TAA, let there be two other domestic coal producers who each initially produce 10 tons of coal. Let them be identical to our original producer in every respect *except* that they have different opportunity costs of coal production. Suppose a high-cost producer sells coal at a market price of $250 per ton and has an opportunity cost of $240 per ton (or $2,400 for 10 tons). In addition, suppose a low-cost producer can supply 10 tons of coal at an opportunity cost of $1,500. Finally, let us designate our original

[1]We are ignoring the gains consumers presumably obtain from consumption of additional coal due to the reduced price of coal.

[2]The level of compensation chosen for this example is equal to the difference between the original domestic price of coal and the new international price.

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supplier, who has an opportunity cost of $2,100, the medium-cost producer.

Now assume that foreign coal producers offer coal at a price of $225 per ton and domestic producers who exit the industry receive compensation of $25 per ton (or $250 for 10 tons). The high-cost producer exits the industry, because he would receive $250 from TAA while forgoing only $100 in profits. And this exit would be efficient, because the domestic cost of coal for the high-cost firm is $2,400 while the foreign cost is $2,250. In contrast, the medium-cost producer, whose exit from the coal industry is inefficient, bears a $250 loss from the foreign competition but is compensated $250. Finally, the low-cost producer stays in the coal industry. It is efficient and profitable for him to do so, because his opportunity cost of production is substantially lower than that of the foreign producers. However, by staying in the industry, the low-cost firm loses $250 of producer's surplus. That loss is the result of foreign competition, yet the firm receives no compensation. In sum, TAA differentially benefits high-cost producers who, by definition, have the least to lose from foreign competition—because they would not be in the market in the first place. Put another way, producers with low costs, who continue to compete with foreign rivals, bear larger losses and receive *no* compensation.

Demand and Supply Analysis

The analysis is further developed in Figure 1. Let D represent the demand for shoes. S is the domestic supply of shoes. It also represents the domestic opportunity cost of shoe production—that is, the marginal cost of shoes (MC). In the absence of foreign trade, domestic producers will produce Q^* shoes at a price of P_d. Now suppose that the domestic economy is opened to trade and that the world price of shoes is P_w. In the absence of any compensation for domestic shoe producers, domestic consumption will increase to Q_c and domestic production will decrease to Q_p. The economy will import Q_c - Q_p shoes. The net gain in domestic welfare is given by the combined areas of triangles d and e in the diagram. Triangle d represents the gain due to replacing relatively high cost domestic producers with low-cost foreign production. Triangle e represents the gain in consumer surplus resulting from increased consumption. The two triangles combined represent the amount by which the increase in consumer surplus exceeds lost producers' surplus.

Now suppose that legislation is enacted that provides compensation to domestic producers when they exit the industry because of foreign competition. Although the value of producer resources in alternative

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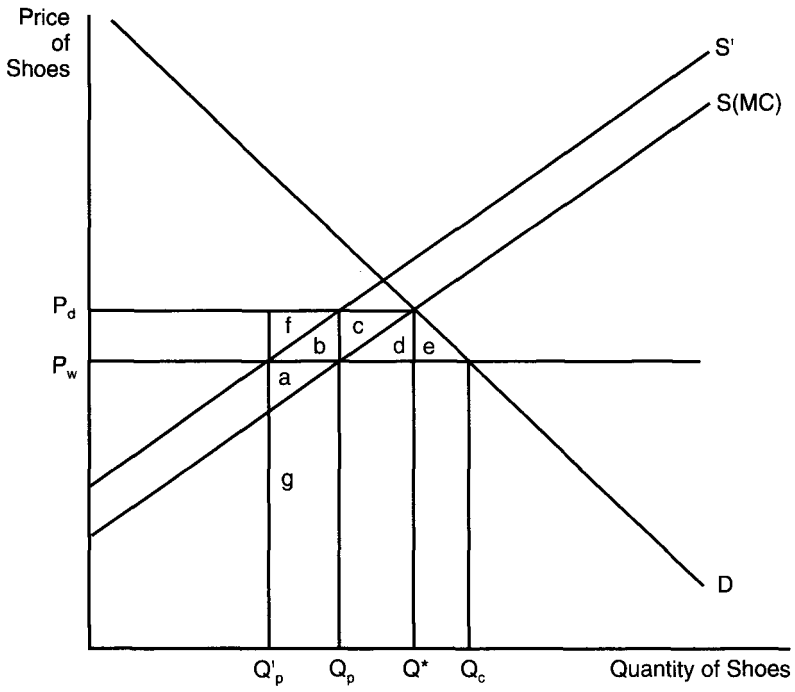
FIGURE 1

SOCIAL COST OF TRADE ADJUSTMENT ASSISTANCE



uses is still given by S, the compensation is an implicit tax on domestic production and, consequently, shifts the domestic supply of shoes to S'. *There is a further reduction in domestic production from* Q_p to Q'_p. This compensation-induced decrease imposes a welfare loss on the economy equal to the the area of triangle a in the diagram. This loss is the result of lower cost domestic producers being replaced by higher cost foreign producers. In other words, when domestic production of shoes is reduced from Q_p to Q'_p, foreign suppliers increase their claims on domestic output by the combined areas of $a + g$, while the released resources from the domestic shoe industry produce other goods and services valued by domestic consumers at the smaller amount represented by quadrangle g.

The magnitude of the welfare loss associated with TAA-induced resource misallocation depends, of course, on the amount of compensation that is granted. To illustrate, let us begin with a plausible scheme in which compensation is based on the difference between the price of shoes before and after trade liberalization. Such a compensation scheme would impose an implicit tax and corresponding vertical

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displacement of the domestic supply curve equal to $P_d - P_w$. The supply curve shift in Figure 1 is that amount. With compensation at that level, the welfare loss represented by triangle *a* is exactly equal to that portion of the original welfare gain represented by triangle *d*. Compensation has eliminated the gain associated with lower production cost but left that portion of gain, triangle *e*, associated with increased shoe consumption.

Obviously, if the level of compensation were to be increased, the loss due to resource misallocation would also increase. *It is possible for compensation to be set so high as to offset all of the initial gains from trade liberalization.* Perhaps this will not seem a likely outcome, but it is important to remember that political, not economic, considerations will set the level of compensation. Also, it is worth noting that the welfare gain (triangle *e* in the diagram) associated with increased consumption will be smaller, the less elastic is domestic demand for the product and, correspondingly, this loss will be more rapidly offset by excessive compensation.

When compensation is based on the trade-induced decline in domestic shoe prices, the actual compensation paid to displaced resources will be equal to the total loss of producer surplus experienced by those resources. Compensation paid will equal the sum of the areas of triangles *b*, *c*, *d*, and *f*. Lost producer surplus associated with the decline in domestic production from Q^* to Q'_p is equal to the sum of areas *a*, *b*, *c*, and *f*. All of these triangles are equal in area in this case.

Owners of resources that would have exited the industry even in the absence of compensation are actually overcompensated relative to lost producer surplus ($c < (c + d)$). The additional resources that exit because of the availability of compensation actually are undercompensated for their losses due to trade liberalization. Lost surplus for these resources is $a + b + f$, while compensation received by them is only $f + b$. These resources exit because once trade liberalization is in place, the effective choice with which they are confronted is to remain in the industry and receive producers' surplus equal to the area of triangle *a* or to leave and collect compensation of $(b + f) > a$. The rather perverse distributional implication of the compensation is that those resources that lose the least as a result of trade liberalization actually are overcompensated and end up being net beneficiaries. Resources that exit only because of compensation are undercompensated for the total loss experienced by liberalization and those resources that remain in the industry receive no compensation at all.

A Multi-Period Model

The preceding example is a single-period model and, as such, might well be suspected of overstating the case for compensation-induced

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inefficiency. If compensation were to cease after only one period, workers who inefficiently switch occupations to obtain compensation, switch back once the compensation ceases to be available. In this circumstance, the distortion is only temporary and of considerably reduced importance. However, in the real world, TAA is designed to train displaced workers for new occupations. As opposed to simple compensation, this training orientation ensures that the welfare loss extends across multiple periods.

Returning to our first example, consider the worker who produces 10 tons of coal at a price of $250 per ton. Suppose his next best alternative consists of training for a job as a computer programmer. After the training, he could produce 50 programs valued at $50 each. However, the training itself costs $4,000.

At the original price of coal, it is not efficient for the coal miner to retrain for the computer industry, even though the value of his output in both sectors is identical. This is because there is a real cost to the switch. Suppose that the appropriate social discount rate is 10 percent. The $4,000 cost of training in the current period is equivalent in present-value terms to a $400 annual perpetuity—that is, the $4,000 invested in training a coal miner is not available for alternative investment and correspondingly reduces the output of other goods and services by $400 in all future periods. It is efficient for the coal producer to switch only if the price of coal falls to $210. Moreover, in the absence of TAA, the coal producer will only switch if the price of coal falls to that level or below.

Suppose, however, that TAA covers the full costs of training if a domestic producer is harmed by foreign competition. In that case, if the price of coal drops below $250, the coal miner has an incentive to switch. Suppose that the price of coal drops to the world price of $225 as in our earlier example. The coal miner takes advantage of the TAA to shift to computer programming. The domestic economy gains $2,500 in computer services but loses $400 in return on alternative investment in perpetuity. New goods and services worth $2,100 are available per period of because of the TAA-induced switch ($2,500 in computer programs − $400 lost return) but foreign claims on domestic output are $2,250 per period. The economy is $150 poorer per period than it would be in the absence of TAA.

Unlike the TAA-as-transfer case, where the welfare cost will only persist in the period(s) when the transfer is in effect, TAA-as-training ensures a welfare cost persists indefinitely. *The welfare costs of TAA-as-training are the same qualitatively as the case of TAA-as-transfer. More important, the TAA efficiency cost extends beyond the single period in the more realistic training case.*

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There are, of course, many coal workers who have the potential, with training, to switch to alternative occupations. Suppose, as seems likely, that because of differences in innate productivity due to such factors as age, intelligence, locational preference, etc., the switching price differs among those workers. In the absence of TAA, some would invest in training and switch occupations if the price of coal were to fall to $225, for others the price would have to fall to $210, and so on.

If the government were to offer a lump-sum training grant to all displaced coal workers, those who would accept could be divided into two groups. One group are those who would not have undergone training and switched occupations unless the training is financed, at least in part, by a government grant. Their switch to alternative occupations is inefficient. The second group comprises individuals who would have switched even without the government assistance. Their training and movement into alternative work is efficient. However, because the training is financed by the government rather than the trainees, two potential sources of welfare cost arise even with this group.

First, there is a welfare cost associated with raising tax dollars to finance their training. The higher the marginal welfare cost of taxation, the greater is this loss from TAA. Second, because the grant is a fixed amount, those workers may decide to undergo more extensive training than is efficient. Consider the possibility that an individual would, in the absence of TAA, abandon coal production and switch to an alternative occupation without any training if the price of coal were to fall to $245. The new occupation might be as a shipping clerk for a truck company and would pay the individual compensation just above that available in the coal industry after the price declined, say, to $246. With TAA, on the other hand, that individual might decide to become a computer programmer in order, at no cost to himself, to earn compensation equivalent to that which he was earning prior to trade liberalization. In our initial example, where TAA came in the form of a cash grant rather than training, the only welfare cost was due to resources leaving the coal industry when it was efficient for them to remain. Now we have the added problem that, even though it may be efficient for some resources to leave the industry, the TAA training assistance inefficiently channels them into the wrong occupation.[3]

[3]The emphasis on training rather than mere compensation has been strengthened in recent legislation. For example, legislation providing for TAA under NAFTA requires workers to be enrolled in training in order to obtain income support (U.S. Department of Labor 1998).

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Some Real-World Examples

Other authors have noted the possibility that TAA distortions can undermine the gains from trade liberalization (Brander and Spencer 1994, Diamond 1982, Smith 1982). However, the full implications of this point, to our knowledge, have not been developed elsewhere. We make no attempt to develop any empirical estimate of the costs of trade distortion or to determine whether they plausibly outweigh the gains from trade liberalization. Rather, our goal is more modest: we shall present two real-world cases where it appears an inefficient substitution out of domestic production occurred.

The first case is found in the work of sociologist Ronald Dore. His 1982 study examined English textile workers who received significant lump-sum compensation if their job loss resulted from a company bankruptcy attributable to foreign competition. He noted that the size of the transfer, called a "redundancy," was enough to finance an extended vacation to the Costa del Sol for many of the workers. He reported that many workers feared that they would lose their compensation (redundancy) if their firms failed to go bankrupt (Dore 1982: 307). It is our inference that workers may have been willing to stay in the textile industry at lower levels of real compensation because they were still better off than in their next best alternative. If, however, the next best alternative employment is sweetened by a public policy that offers the equivalent of an expense-paid vacation package, workers will increasingly be willing to abandon the textile industry in pursuit of alternative occupations. More important, that switch may well be an inefficient use of worker resources.

Another, more recent, example relates to NAFTA trade assistance. In Oregon, a timber mill laid off workers temporarily in response to reduced lumber availability, which the Department of Labor deemed to be NAFTA related. However, "the reluctance of some workers getting aid to return created a skilled labor shortage and that contributed to the mill's decision to shut down permanently" (Richards 1997: A9). Again, it is likely that the Oregon workers would have returned to the mills had the NAFTA compensation not been available. It is also likely that their move from the lumber industry was an inefficient allocation of their labor resources.

Conclusion

TAA is not a costless way of smoothing a transition to a regime of free trade. If exiting an industry in the presence of foreign competition is "sweetened" by government transfers, then some potentially efficient competitors will exit the industry. In addition, the equity implica-

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tions of TAA are peculiar. Those producers who would leave the industry in the absence of compensation are "overcompensated." Those who exit because of the compensation are "undercompensated." Finally, those who remain in the industry in the presence of foreign competition obtain no compensation. Both the magnitude of those compensation-induced trade distortions and their precise distributional implications are beyond the scope of this paper. However, it is clear that any policy appraisal of a trade-compensation program's structure or desirability should surely consider those costs.

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The Problem of Lemons and Why We Must Retain Juvenile Crime Records

T. Markus Funk and Daniel D. Polsby

Most state and federal statutes "expunge" (destroy or seal) a young offender's record of juvenile delinquency when he reaches age 17 or 18 (Funk 1996: 887). The justification for this policy is that it allows young men (and young women) who have been guilty of "youthful indiscretions" to enter adulthood without the heavy stigmatic freight of a criminal record (e.g., Volenick 1975: 169). At bottom, expungement laws seek to prevent employers, police officers, and even judges from finding out about a person's criminal activities during his minority. Although a policy that allows for the expungement of isolated or minor acts of juvenile delinquency may not raise some of the problems discussed in this article, current statutes tend to aggressively expunge records full of serious and repeated criminal conduct. This article will discuss some of the not so obvious consequences that result from such expungement schemes.

Young Offenders Cause Much Damage

No one will quarrel with the humanitarian motives that support contemporary expungement schemes, but the unfortunate truth is that the policies have often failed to keep pace with reality. Unlike the juvenile offenders of 75 years ago, the delinquents of today are committing very "adult" crimes, involving vast harm to both persons and property. A 1995 U.S. Department of Justice study, for example, found that while the adult arrest rate for murder had risen a mere 9 percent between 1983 and 1992, the corresponding juvenile arrest rate jumped 128 percent. Juvenile arrests for aggravated assault went

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up 100 percent during that time (Snyder and Sickmund 1995: 113). And according to a 1991 survey, juveniles between the ages of 12 and 18 were responsible for approximately 28 percent of all personal crimes such as rape, personal robbery, aggravated and simple assault, and theft from a person (Snyder and Sickmund 1995: 47). Some criminologists fear that, by the year 2010, juvenile arrest rates for violent crime may more than double and juvenile arrest rates for murder may increase by 145 percent (Snyder and Sickmund 1995: 111). If that happens, the tragedy will follow this age cohort through the several generations of its life, for the vast majority of studies—both domestic and international—conducted on deviance show that patterns of chronic criminality remain remarkably stable throughout the late teens and into adulthood (e.g., Caspari and Silva 1995: 495–96; Constantino 1995: 260; Farrington 1995: 929).

Labeling Theory

Labeling theory is the immediate intellectual ancestor of the spate of expungement laws that were passed during the 1960s and 1990s. Labeling theorists thought that society at large should shoulder the blame for the actions of delinquent children (e.g., Becker 1963: 9; Blumer 1969: 78–82). They argued that the destruction of a harmful police record would remove a major impediment in the rehabilitation of an erring child, because the very act of explicitly labeling a behavioral deviant as such increases the likelihood that he will in fact adopt a criminal identity and live with it through life. As criminologist and labeling theorist Howard Becker (1963) wrote in *Outsiders*, "deviance is *not* a quality of the act the person commits, but rather a consequence of the application by others of rules and sanctions to an 'offender.' The deviant is one to whom the label has successfully been applied; deviant behavior is behavior that people so label."

The emphasis in aggressive expungement thus was, and is, on the perpetrator's youth and inexperience, rather than on the reality of his crimes and his unabated criminal tendencies. It is neither obvious nor even probable that this criminal law reform has in fact been beneficial to juvenile offenders themselves, let alone to society as a whole. There is an obvious mismatch between the regular institutions of the criminal law, which are meant to inflict personal shame and pain on offenders, and arrangements within the juvenile justice system that are meant—and understood as meant—to excuse, depreciate, or give amnesty to the acts that are ordinarily supposed to lead to shame and pain. Of course the juvenile justice system does occasionally deal with children too young to appreciate the moral dimensions or real-

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world consequences of their behavior, but by far the majority of its caseload is taken up with the recidivistic and violent adolescent offenders, who usually do possess the cognitive and moralizing capacities that allow them to appreciate the distinction between right and wrong.

There are good reasons to be skeptical of some aspects of juvenile justice. But one should readily grant the central empirical claims of labeling theory. Being labeled as a "criminal" at an early point in life must surely injure an individual's life chances. Nor should there be any doubt about the fact that young men often engage in impulsive, seemingly pointless, high-risk, egocentric behavior—which often means criminal behavior—nor that the disposition to behave in this way does not follow most of them very far into adulthood.

Distributional Consequences of Forgetting Criminal Pasts

Obviously there are distributional consequences that flow from the application of expungement laws. Some people win and some people lose from these laws' operation. Expungement schemes assume that the class of juvenile offenders whose records have been expunged would gain, and that the class of persons (such as employers, admissions officers, prospective spouses, creditors, licensors, and joint venturers—which for the sake of brevity we will hereafter collectively refer to as "employers") who might be negatively influenced by the unavailability of delinquency records would be the losers. However, the matter is not so simple. A better understanding of the problem and its consequences is important to advancing the work of those specially concerned with increasing the welfare of children. It is far from obvious that the set of children with records of delinquency to expunge are made better off by the practice of expungement. If the dynamics of such laws were better understood, perhaps those who support such laws would be less enthusiastic about them.

Pro-Expungement

The rationale of expungement statutes begins with a recognition that a juvenile criminal record is not necessarily a good predictor of a person's current behavior—which is, after all, what the group we have described as "employers" are primarily interested in. Such prior involvement with the law could lead to sloppy or unfair inferences about how someone is likely to perform on the job. Social science cannot substantiate the fireside induction that, because this job applicant snatched a purse 20 years ago when he was 15, he is unlikely to

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succeed driving a fork-lift truck in a warehouse today. Indeed, in many cases the curbstone predictivity of such information will be so low as to make it nearly worthless. What harm, therefore, could there be in depriving employers of such low-quality information?

Indeed, many members of the employer class will not even be *theoretically* worse off because of expungement laws. For example, employers who would have hired the applicant even had they known the suppressed information are certainly no worse off, having been deprived of information they would not have relied upon in any event. And even employers who would not have hired had they known the suppressed information will be no worse off if the applicant turns out, having been hired, to perform satisfactorily. The actual losers are a narrower class: those who would have turned down an applicant with an expunged record because of his record of delinquency, who instead hire the applicant, and are damaged thereby because the applicant, once hired, does not perform up to expectations that were fostered by his statutorily doctored record. That is not necessarily a large class, and it is certainly one that, on the whole, is richer and thus in a better position to bear the social costs associated with the suppression of this criminal-history information (at least when compared to the class of juveniles with delinquency records).

The idea is to subsidize a class of juvenile offenders at the expense of employers and such other members of society—effectively everybody—to whom employers are able to pass along such costs. It makes a great deal of sense, moreover, for there to be a careful debate about how the costs of late male adolescence should be borne in society, because society requires mature men, and cannot have them without having to cope with boys and immature men first. It is possible, for example, to think of the rules concerning the duties of possessors of land to trespassing children as an effort to find a broader cost-bearing base than simply the child or its family alone. Perhaps some similar concession is rightly to be accorded to delinquent juveniles, young men especially, whose predominance in the population of social deviants is for all intents and purposes a statistical constant irrespective of how harsh or permissive a given society's criminal justice system may be.

On the Defective Premises of Expungement Laws

The above argument is meant charitably to reconstruct the rationale of expungement statutes. We do not aim to contribute to that conversation, however. Indeed, it is our contention that the social cross-subsidy mechanism that is imagined by expungement statutes misses the mark, and that things surely must work out very differently in the real world.

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Expungement statutes are based on theories of human behavior, of social incentives and of rational decisionmaking that we think are at best incomplete and at times naive. The cross-subsidy effected by the policy is not from employers to former delinquents, but rather it is from nondelinquent to delinquent members of the same age cohort, with a distinct surtax on black, Hispanic, and poor members of that cohort. This form of social wealth-transfer is not only perverse in that it boils down to a more or less explicit subsidy for serious misbehavior, but it is also deeply destructive because the policy taxes those who have not misbehaved to enrich members of the same class who have. Moreover, it tends to efface the distinction between "good" and "bad," to make suckers out of well-intending individuals who want their behavior to reflect that distinction, and to perpetuate and increase the accuracy and economic value of negative racial stereotypes. Finally, it does not have these effects in secret or through some complicated chain of cause and effect that nobody understands, but on the contrary seems to be well understood by everyone connected with the system.

The Market for Lemons

Imagine a sentencing judge facing a youthful adult offender following the latter's conviction for a crime. In many expungement jurisdictions the sentencing judge must necessarily ponder whether the 19-year-old defendant before him has thus far not run afoul of the law, or whether he instead is a recidivist, because any verifying or impeaching information has been permanently physically purged from the individual's file. The judge in this scenario is situated identically to, and is a member of, the class which we have above designated "employers." Because of expungement, all must act in a pall of statutorily created uncertainty.

A generation ago, economist George Akerlof (1970) explained the changes one could expect to see in the behavior of risk-averse consumers who were attempting to estimate the correct bid price for commodities in a market where the quality of individual units was (1) liable to significant variation and (2) difficult or impossible for a potential consumer to ascertain. For example, in the securities market there is often a large disparity of information between investors on the one hand and the issuers of securities on the other concerning the securities' quality. Debtors generally possess much more information about the safety of a bond—in other words about their own creditworthiness—than prospective creditors do. The result of this information asymmetry is that prospective investors will be willing to bid an amount that assumes that the security has only some average probability of

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default in a range of uncertainty. Sellers of low quality securities in such a market will profit more, and sellers of high quality securities will profit less, as a corollary of this quality uncertainty. The standard cure for this market imperfection is reliable information. In the securities market, for example, an issuer can purchase insurance that will reveal the true default probability, or make some other sort of disclosure arrangement with the issuer.

Akerlof considered this in the context of the market for used cars. In the used car market there is also an informational asymmetry, analogous to that in the securities market, between the seller of a given used car and its buyer concerning the quality of the car. The seller has driven the car for years and knows what his own habits have been concerning scheduled maintenance items that can significantly affect the service life of machinery. This information is difficult, and practically speaking impossible, for a purchaser to discover for him or herself. Buyers as a result are often forced to rely on various approximation techniques that allow them to make inferences from the visible to the invisible: for example, they might reason that a well-groomed car, carefully detailed and with few dings and scratches, is more likely to possess well-maintained mechanicals than an obvious jalopy.

It isn't necessarily so, however. Most people soon learn that such inferences are subject to type-I error (in other words, affirming the untrue proposition that a pretty car is therefore a good car). A potential buyer bidding on a used car must arrive at a price based on conjecture supplemented with approximation techniques relative to some of the most important aspects of the deal, and he or she therefore can be expected to submit a meaningfully lower offer for the car than someone who knew that, as a matter of fact, the seller had taken awesome care of the machine. This offer will in fact tend to converge with the offer that would be submitted by a bidder who knew for a fact that the previous owner only changed oil when the dipstick indicated "empty." A market of this sort could be expected to attract, by tendency, outwardly beautiful but poorly maintained or otherwise invisibly defective cars. Over time, whatever value widely used estimation techniques might have had to begin with would tend to erode, hence increasing bidders' uncertainty about the quality of the product and pushing down the rational bid price. The way to escape from this failing market is to find a way to upgrade the information that flows from seller to buyer concerning the "true" value of the car. One could deal only with relatives or friends, provide (or demand) certified service records, or purchase from an established dealer who will have caused an expert inspection of the machine to be conducted, and who will offer a

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warranty that the product will at least meet certain agreed-upon expectations for at least an agreed-upon period of time. Naturally, a quality car *and* accurate information about its (high) quality is significantly more valuable than the car without the information. This is one reason why people pay auto dealers more for a given used car than they would offer an unknown stranger for it.

Some Effects of the Lemons Problem on Sentencing

A sentencing judge in a jurisdiction that aggressively expunges juvenile crime records by destroying them is in very much the same position as the prospective creditor or car buyer. A young adult is convicted of some crime and appears for sentencing. Now the judge must determine whether he is in fact a first (or second, etc.) offender, or whether he instead is so merely as a result of a statutorily imposed fiction. Assuming judges—and others in the employer class—might regularly observe the distinction between first offenders and chronic ones and make real-world consequences turn on it, the existence of uncertainty concerning whether one was dealing with an ingenue or a recidivist offender could be expected to produce two altogether unwelcome results. Just as one could expect information-impaired bidders to bid too little for good used cars and too much for bad ones, one could expect judges to sentence career criminals too leniently and genuine first offenders too harshly, but with a tendency, depending on the judge's degree of risk-aversion, toward being too harsh with actual first offenders.

Not that judges would be uninterested in this datum, of course. No doubt they consciously or unconsciously try to work around their ignorance of an offender's background by substituting estimation techniques for particularized information, including, one can hardly doubt, looking at easily ascertained and roughly correlating facts such as an individuals' race or socioeconomic class. There is no reason to think, in other words, that by destroying real information, expungement statutes make the world any less dependent on information than it was before. If employers (judges, etc.) cannot get good information, they will do their best with bad information. To the extent that the rate of serious criminal offending among poor and/or black or Hispanic adolescents is believed to be higher than that of their white and/or wealthier counterparts, one should not be surprised if it turned out to be the case that black, Hispanic, and poor first-time offenders are treated somewhat more harshly in expungement jurisdictions than wealthier white first-time offenders are.

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Because the economic distinction between well-maintained and poorly maintained used cars is small due to an absence of information about which is which, car owners have diminished incentives to maintain their cars properly. At least this much is true: to whatever extent their maintenance decisions are based on a desire to keep up the resale value of their car, an information-impaired used car market diminishes that incentive and should tend over time to produce a more poorly maintained fleet of cars for the resale market than would be the case in a world where maintenance information was highly reliable and easily obtained. The same dynamic should also apply to people's behavior more generally. To some degree, people choose good behavior in the present because, in the future, they want to enjoy a reputation for good behavior. To whatever extent incentives of this kind matter in determining people's behavior—and of course the criminal law assumes that they do indeed matter—the effect of expungement laws is to give evilly inclined adolescents less reason to refrain from evil at the same time that they give well-motivated adolescents less reason to continue to be good.

Conclusion

Proponents of expungement laws believe that, in effect, they take what would be a very concentrated harm (a juvenile criminal record), and then leach its hardship out into the society as a whole, which they feel is far better able to bear these costs as a part of the overhead of daily life. Prodigal sons need to be forgiven, and there is no percentage in repentance if one's adolescent follies are to follow one throughout life. In fact, though, it is highly doubtful that "society" will bear the burden for the prodigal. Rather, the burden will be borne, for the most part, by members of the offender's own age cohort, by people who look like him but who do not have criminal records. The subsidy is not from the rich to the deserving, but from the well-behaved to the ill-behaved. What is possibly worse, expungement laws increase the value of racial stereotypes and therefore serve to perpetuate them.

What, then, is to be done about the youthful indiscretions of juvenile offenders? Are their missteps to follow them forever? One of the assumptions on which expungement laws rest is that only lawyers, only people who draft and sponsor reform statutes, will really and truly know how to forgive and forget. We need expungement statutes, in other words, because employers, the families of prospective spouses, judges, admissions officers and so on, can be expected to abuse their positions and to be bigoted toward people with past criminal entangle-

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ments, instead of merely being skeptical about whether they have straightened themselves out.

It is a mistake to rely on expungement statutes for this purpose. While it is undoubtedly true that an individual's isolated and minor past scrapes with the law will have little or no current relevance to decisions "employers" may make about that individual, sometimes they may. In any case, "employers" will often have virtuous incentives for sorting things out and deciding which is which. It would be extraordinary if a simple statutory rule ("expunge") could get it more nearly right than the case-by-case judgments of people trying to evaluate an individual's promise or qualifications. The best argument for keeping expungement laws seems to be that they flatter the vanity of those who embrace them. That is not a good enough reason.

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A Vote for Perot Was a Vote for the Status Quo

William A. Niskanen

In 1992 Ross Perot received more votes than any prior third party candidate for president, and the vote for Perot in 1996 was only slightly smaller than that for George Wallace in 1968. There remains, however, substantial confusion about how to interpret the vote for Perot.

Four Hypotheses

Most political analysts seem to have concluded that most of the Perot voters would have otherwise voted for the Republican candidate, presumably based on the defeat of the Republican candidate in both elections and Perot's campaign focus on fiscal responsibility. Careful polls after the 1992 election, however, indicate that the composition of Perot voters was more like the total electorate than the composition of Republican voters—in terms of income, education, religion, and their vote in 1988—but with substantially more concern about current and future economic and fiscal conditions. And Perot's own anti-establishment campaign rhetoric seems unlikely to have appealed primarily to otherwise Republican voters.

An analysis of the popular vote for president in the 1992 and 1996 elections, I suggest, provides a better basis for estimating the effects of the Perot vote and the revealed concerns of the Perot voters. These two elections share two common conditions and two important different conditions: The common conditions were that the incumbent president was running for reelection, and Perot was the major third party candidate in each election. The most important different conditions were that the incumbent president was a Republican in 1992

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but a Democrat in 1996 and that economic conditions had improved more substantially over the four years prior to the 1996 election.

These two elections provide a basis for sorting out among four alternative explanations of the Perot vote:

1. Most of the Perot voters would have otherwise voted for the Republican candidate.
2. Most of the Perot voters would have otherwise voted for the Democratic candidate.
3. Most of the Perot voters would have otherwise voted against the incumbent candidate of either party.
4. Most of the Perot voters would have otherwise voted for the incumbent candidate of either party.

An analysis of the effect of the Perot vote on the incumbent candidate's share of the total major party vote provides a sufficient basis for selecting among these four hypotheses, based only on the sign of this effect in the two elections. For example, if the Perot vote reduced the Bush share of the total major party vote in 1992 but increased the Clinton share in 1996, as is the conventional wisdom, this pair of signs is most consistent with the first hypothesis. Similarly, each of the other possible pairs of signs of the Perot vote effect is most consistent with one of the other hypotheses. (Table 1 lists the various possibilities.) Estimates of the sign and magnitude of the Perot vote effect in each of the two elections are presented following a discussion of the characteristics of Perot voters.

Who Were the Perot Voters?

First, it is useful to summarize the available information about the Perot voters. The most detailed information is from an exit poll of 15,232 voters after the 1992 election, a poll prepared for the networks

TABLE 1

SIGN OF THE PEROT VOTE EFFECT UNDER THE FOUR HYPOTHESES

Hypothesis	Election	
	1992	1996
1. Republican	−	+
2. Democratic	+	−
3. Protest	−	−
4. Status Quo	+	+

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by Public Opinion Strategies (1993). Table 2 presents the most relevant results from this poll.

The most striking observation from these data is that the composition of those who voted for Perot in 1992 is very similar to the composition of all voters. Other data from the same exit poll (not shown) also indicated no significant difference by religion. The largest differences in the demographics of the Perot voters were a somewhat smaller percent of minorities, those over 60, and those with postgraduate education.

More important, "The bottom line is that Perot voters are more identifiable by their attitudes rather than their demographics" (Public Opinion Strategies 1993: 1). A higher percent of the Perot voters, especially compared to the Bush voters, regarded their personal finances as worse and the prospects for the national economy as poor. Later polling by Public Opinion Strategies indicated that the Perot voters were the most pessimistic about the direction of the country and were much more focused on economic issues, especially the federal budget deficit.

The characteristic Perot voter, in summary, was an average voter with an attitude. For all that, it is not obvious how the Perot vote affected the 1992 and 1996 elections and how this group may vote in future elections when Perot is not a candidate.

What Were the Effects of the Perot Vote?

My analysis of the effects of the Perot vote is based on regression estimates of the following vote function in both the 1992 and 1996 elections[1]:

$$(V/(1-V)) = e^{C+bVL+cO}(Y/YL)^{d}, \text{ or}$$
$$\ln(V/(1-V)) = C+bVL+cO+d(\ln(Y/YL)), \text{ where}$$

V = popular vote for the incumbent president as a share of the major party popular vote,
VL = popular vote for the winning candidate in the prior election as a share of the total popular vote,
O = popular vote for all minor party candidates as a share of the total popular vote,
Y = real per capita personal income, and
YL = Y in the prior election year.

[1]This vote function is similar to that which I tested with a time-series sample in Niskanen (1979).

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TABLE 2

CHARACTERISTICS OF VOTERS IN 1992

Characteristics	All	Candidate		
		Clinton	Bush	Perot
		(Percent of Voters)		
Sex				
Men	47	45	47	52
Women	53	55	53	48
Race				
White	87	79	94	94
Black	8	16	2	3
Other	4	5	4	4
Age				
18–29	21	21	19	24
30–44	36	34	36	39
45–59	23	22	24	23
60+	20	23	21	13
Education				
No HS	7	9	5	7
HS Grad	25	25	25	27
Some Col	29	27	29	32
Col Grad	23	21	26	23
Postgrad	16	18	15	11
Income				
Up to 15K	14	19	9	13
15–30K	24	25	23	25
30–50K	30	28	23	32
50–75K	20	18	22	19
Over 75K	12	10	16	10
Personal Finances				
Better	24	13	40	18
Same	41	38	46	37
Worse	34	47	13	44
National Economy				
Good	19	4	41	10
Not Good	47	46	47	49
Poor	32	48	10	40
Party Identification				
Democratic	38	68	10	26
Republican	34	8	67	31
Other	27	24	23	43
Vote in 1988				
Bush	53	25	84	56
Dukakis	27	51	4	17
Other	2	3	0	3
No Vote	15	16	10	21

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First, a word about the test equation: Statistical criteria suggest the use of the logit transformation $\ln(V/(1-V))$ rather than V as the dependent variable; the logit form is unbounded, and the variance of the residuals is symmetric. The coefficients of a vote function with V as the dependent variable would be equal to $V(1-V)$, or about .25, times the estimated coefficients of the above test equation. The constant C, in this case, reflects the sum of two effects—the advantage of being the candidate of the incumbent party and the advantage of the specific candidate that is common to the whole sample. The variable 0 includes the votes for all minor party candidates but is only slightly larger than the Perot vote share. The sample for each regression is the 50 states plus the District of Columbia. All of the data are from the *Statistical Abstract of the United States* (1997). The two vote functions are estimated by a weighted least-squares regression, where the weight is the electoral college vote of each unit; this yields a near perfect fit for the largest states with a small increase in the residuals for the smallest states.

For this paper, the most important finding from the regression results summarized in Table 3 is that the Perot vote increased the *incumbent president's share* of the major party vote in both the 1992 and 1996 elections by drawing primarily from votes that would have

TABLE 3

WEIGHTED LEAST-SQUARES ESTIMATES OF THE VOTE FUNCTIONS

	Election	
	1992	1996
Independent Variables		
Incumbency	−2.631	−2.286
	(.132)	(.207)
Prior Vote	4.044	4.620
	(.218)	(.366)
Minor Party Vote	1.343	3.927
	(.296)	(1.016)
Income Change	1.917	1.245
	(.247)	(.787)
Weighted Statistics		
Adjusted R-squared	.933	.864
S.E. of Regression	.092	.155

NOTE: Numbers in parentheses are the standard errors of the coefficients.

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otherwise gone to the opposition candidate. The Perot vote helped Clinton in 1996 more than it helped Bush in 1992 but was strongly significant in each case.

The other findings from these regressions are interesting but less important. Clinton's incumbent advantage in 1996 was somewhat higher than Bush's advantage in 1992, and the Clinton vote share in 1996 was slightly more dependent on his vote share in the prior election. The variance of the change in real per capita income among the states, however, was more important to the Bush share of the major party vote. The differences of these several effects between the two elections, however, are not statistically significant.

These two vote functions, plus the national averages of the independent variables, also make it possible to estimate how much of the popular vote for Bush in 1992 and for Clinton in 1996 was attributable to each of the several independent variables. These estimates are summarized in Table 4.

Again, for this paper, the most important issue is the effect of the Perot vote. In 1992, the minor party vote increased the Bush share of the major party vote by a net 6.4 percentage points by drawing votes that would otherwise have gone to the Democratic candidate; most of the minor party vote, however, would not otherwise have voted. Bush would have lost by an even larger margin in 1992 if not for the minor party vote. In 1996, the minor party vote increased the Clinton share of the major party vote by a net 9.8 percentage points by drawing votes that would otherwise have gone to the Republican candidate; in this case, however, only a small share of the smaller minor party vote would not otherwise have voted. Clinton would apparently have lost the election in 1996 if not for the minor party vote.

TABLE 4

SOURCE OF THE POPULAR VOTE FOR BUSH AND CLINTON

	Election	
Condition	1992 (Percent of the Major Party Popular Vote)	1996
Incumbency	6.7	9.2
Prior Vote	31.7	33.3
Minor Party Vote	6.4	9.8
Income Change	0.9	2.1
Total	45.7	54.5

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In both cases, again, the minor party vote increased the incumbent president's share of the major party popular vote.

Another finding is that conditions that were common to the whole sample favored Clinton by 2.5 percentage points more in 1996 than they helped Bush in 1992. In both cases, 60 to 70 percent of the variance among the states of the vote for the incumbent president was explained by the popular vote by state for the same candidate in the prior election. Economic conditions favored Clinton more in 1996 than Bush in 1992, but the variance of the change in real per capita income among the states explained only 2 to 4 percent of the vote for the incumbent president by state in these elections.

Conclusion

The characteristic Perot voter, in summary, was very similar to the average voter, except for a concern about his or her personal economic condition and an anxiety about future general economic conditions. One might think that this would lead to a vote for change, drawing largely from votes that would otherwise go to the candidate of the incumbent party. In both 1992 and 1996, however, the minor party vote, almost all of which was for Perot, increased the *incumbent president's share* of the major party vote, drawing from votes that would have otherwise have gone to the opposition candidate. Anxious voters, in these two elections, apparently voted against change. In this sense, the vote for Perot was a vote for the status quo.

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Securities Units of Banking Conglomerates: Should Their Location Be Regulated?

João A. C. Santos

The separation between commercial and investment banking has been a distinctive feature of the U.S. financial system for decades. In 1933, reacting to the wave of bank failures that followed the Great Depression, Congress passed the Glass-Steagall Act separating the two industries. For more than 30 years, firms on both sides seemed to lack the incentive (or the ability) to explore some of the gray areas of that regulation. Since the 1960s, however, commercial banks and securities firms have tried to expand their activities into each other's strongholds. These attempts have contributed to a gradual erosion of the barriers separating them.

Currently, the federal agencies charged with regulating and supervising commercial banks, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve System (Fed), all agree on easing the barriers separating the two industries, provided that securities activities are housed in a separately capitalized unit of the banking conglomerate. They have, however, argued for different regulations on the location of the securities unit in the conglomerate. The OCC and the FDIC have manifested their preference for a regulation that allows banks to choose between the bank parent model and the holding company model. The Fed has expressed its preference for a regulation requiring the holding company model.

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João A. C. Santos is Economist at the Bank for International Settlements. He wishes to thank James Thomson, Joseph Haubrich, James A. Dorn, and an anonymous referee for useful comments and suggestions. Part of this research was developed while the author was at the Federal Reserve Bank of Cleveland. The views stated herein are those of the author and are not necessarily the views of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System or of the Bank for International Settlements.

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The difference in the regulatory agencies' proposals has brought increased prominence to the debate on the more general question of whether the location of the securities unit in a banking conglomerate should be subject to regulation. This debate has focused on two issues: one related to the economic implications of the different locations for securities units, the other related to how that location would affect the portion of the banking industry that each agency oversees. This paper reviews the arguments as to whether the location of the securities unit in a banking conglomerate should be subject to regulation. This review is complemented with evidence on the regulations and on the predominant banking conglomerate models in some other countries and in the United States before the Glass-Steagall era.

Commercial Banks in the Securities Business

In the debate over repealing the Glass-Steagall Act, it is usually conjectured that combining commercial banking with investment banking enhances the bank-firm relationship, generates economies of scope, creates conflicts of interest, and poses problems to the safety and soundness of banks (see Santos 1997). It is also conjectured that these effects vary with the location of the securities unit in the banking conglomerate.

Potential Benefits and Costs of Combination

The modern banking literature relies on information frictions to explain the existence of financial intermediaries (see Freixas and Rochet 1997). Firms usually have information about their investment opportunities that is not readily available to outsiders. In this case, delegating certain functions to a financial intermediary reduces the costs of financial intermediation because it avoids the duplication of such functions as gathering relevant information before making the funding decision and monitoring borrowers' actions once they receive the funds to undertake their investment projects. Under these circumstances, it is believed that a bank that also offers securities services can develop a "wider" and "longer" relationship with firms than can a specialized bank.

Increasing the number of contact points between a bank and a firm makes it easier for the bank to gather information about that firm and to use it in a wider set of transactions. For example, it will be relatively simple for a bank to study a firm with which it has a lending relationship for the purpose of underwriting its securities. The expected duration of the bank-firm relationship is also important. Young firms generally obtain funding from banks, but as they mature,

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they often switch to capital markets, a move that in turn requires underwriting services. Unlike a specialized bank, an institution that offers both lending and securities services can fulfill the firm's funding needs throughout its existence. In sum, there seem to be important information advantages associated with offering commercial and investment banking services jointly. Empirical research on these issues confirms that the enhancement of the bank-firm relationship is a source of benefits in terms of both cost and availability of funding (Petersen and Rajan 1994; Berger and Udell 1995).

Another potential advantage of combining commercial banking with securities activities is economies of scope. Several reasons are frequently given as to why that combination may be the source of scope economies in the supply of financial services, such as the banks' ability to use their networks of branches to distribute additional products at a low marginal cost. Economies of scope could also arise on the consumption side. Because of lower search and monitoring costs, a consumer might find it advantageous to acquire a bundle of services from a single bank instead of shopping around for individual deals. Thus, from a theoretical point of view, there seem to exist some important sources of scope economies. From an empirical point of view, however, the debate over the importance of these economies remains unsettled. Research on U.S. banks finds little evidence of scope economies in production, but research on banks in Japan and in some European countries finds evidence of such economies (see Mudur 1992, Forestieri 1993).

When the Glass-Steagall Act legally separated commercial banking from investment banking in 1933, backers of the legislation claimed that they were heading off serious conflicts of interest and threats to the safety and soundness of the banking industry. These arguments continue to be invoked by those who favor maintaining that separation.

Conflicts of interest associated with the combination of commercial and investment banking are said to arise for several reasons, such as the bank's opportunity to impose tie-in deals by coercing borrowers to buy its securities services or have their credit rationed.[1] The critical issue regarding any potential conflict of interest, however, is not its existence per se but whether the parties have incentives and opportunities to exploit it. Working against banks' incentives is the possible impact of such behavior on their reputation, and working against their opportunities is the competition in financial markets and consumers'

[1]For a discussion of other conflicts of interest, see Saunders (1985), Kelly (1985), and Benston (1990).

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expected behavior. For example, if firms perceive that they may be forced into tie-in deals, they can protect themselves by maintaining relationships with several banks. Despite the existence of potential conflicts of interest associated with the combination of commercial and investment banking, empirical research on the period before Glass-Steagall failed to find evidence that banks systematically exploited these conflicts (Kroszner and Rajan 1994; Ang and Richardson 1994; Puri 1994, 1996).

The other most frequently cited justification for not allowing commercial banks to offer securities services is based on the argument that these are risky services which could threaten the safety and soundness of banks. Empirical research, however, appears to disprove the idea that securities activities are highly risky for banks. Research on banks' securities activities prior to Glass-Steagall finds no evidence that these activities were responsible for the bank failures that occurred at the time (White 1986). Studies of the potential risks to existing banks and bank holding companies (BHCs) from offering securities services appear to indicate that such activities give banks some potential, though rather limited, diversification gains (see Brewer, Fortier, and Pavel 1989).

Alternative Conglomerate Models

The potential benefits and costs of allowing banking conglomerates to provide securities services depend to a large extent on their freedom to integrate such services with their current businesses. This integration is greatly influenced by the conglomerate model that the organization is allowed to adopt. In a deregulated system, there are several models that banks could adopt to integrate commercial banking with securities activities. The most common are the universal banking model, the bank parent model, and the holding company model.

In the universal banking model both commercial banking and securities activities are conducted within a single corporate entity. Resources can be shared among the organization's various departments with maximum flexibility, permitting a complete integration of the activities at the lowest cost. In the bank parent model, the securities business is undertaken by a subsidiary of the bank. There is a legal separation between the bank and the securities unit. This imposes some operational separateness between the activities conducted by the two units and, because of limited liability, it confines the bank's loss to its investment in the subsidiary in the event that the securities unit should fail. Finally, in the holding company model, a holding company owns both the bank and the securities subsidiary. As in the bank parent model, there is a legal separation between the two units.

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The critical difference between these two models, however, is that in the latter the securities subsidiary's capital is owned by the holding company while in the former it is owned by the bank itself. Therefore, in the holding company set-up the relationship between the bank and the securities subsidiary is only indirect, while in the bank parent set-up it is direct.

International Evidence on Banking Conglomerate Models

International evidence on the conglomerate models that banks are allowed to adopt to integrate securities activities with commercial banking, together with the model that predominates in each country, provides important insights on banks' preferences. Table 1 presents that information for several countries.

The table highlights two important facts. First, the vast majority of the countries considered allow banks to offer the securities services in-house or through their subsidiaries. Second, in countries where banking firms have more freedom to choose where to locate the securities unit in the conglomerate, they choose in most cases to locate it in a department of the bank. When they choose to implement corporate separateness, they prefer to offer the securities services through one of their subsidiaries.

In the United States, the regulations on the organizational structures that banks are allowed to adopt in order to offer securities services are quite different from those in force elsewhere. Since Glass-Steagall, banks have been permitted to undertake only a very limited set of securities activities in-house. Over time, that set of activities has been expanded, but with the condition that they are housed in a subsidiary of the holding company that also owns the bank. This is one of the reasons why the holding company model has become so important for the U.S. banks.[2]

As a final note, two important caveats should be taken into account when considering the evidence presented above. First, factors idiosyncratic to each country may influence banking firms' choice of the location of the securities' unit in the conglomerate. Second, if there are market imperfections, a certain conglomerate model may predominate

[2]In the United States, banks' securities powers and the organizational models that they are allowed to adopt in order to offer securities services vary with the bank charter. Banks in general are permitted to conduct only a limited set of securities activities in-house. State-chartered member banks can offer some additional securities services if they locate them in a subsidiary of a BHC. National banks and state-chartered nonmember banks are also allowed to offer a broader set of securities services if they locate them in a separate unit, which can be a subsidiary of a BHC or a subsidiary that they own. See the next section for a description of the U.S. regulations.

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TABLE 1

PERMISSIBLE CORPORATE ORGANIZATIONAL FORMS[a]

Countries	Bank Holding Company Permitted	Securities Activities[b]			
		Directly in the Bank	Bank Subsidiary	Bank Holding Company Subsidiary	Most Frequently Conducted in
Austria	Yes, but infrequently used	Yes	Yes	Yes	Bank[c]
Canada	No	No	Yes	No	Bank subsidiary
Finland	Yes, but infrequently used	Yes	Yes	Yes	Bank
Germany	Yes, but infrequently used	Yes	Yes	Yes	Bank
Greece	No[d]	Yes[e]	Yes	No	Bank subsidiary
Ireland	Yes, but infrequently used	Yes	Yes	No	Bank subsidiary
Italy	Yes, widely used	Yes	Yes	No	Bank
Luxembourg	No[f]	Yes	Yes	No	Bank
Netherlands	Yes, widely used	Yes	Yes	Yes	Bank
Portugal	Yes, but infrequently used	Yes	Yes	Yes	Bank & bank subsidiary

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Spain	Yes, but infrequently used	Yes	Yes	NA	Bank & bank subsidiary[g]
Sweden	No	Yes	Yes	No	Bank
Switzerland	Yes, but infrequently used	Yes	Yes	Yes	Bank
United Kingdom	Yes, but infrequently used	Yes	Yes	Yes	Varies

SOURCE: Barth, Nolle, and Rice (1997).
[a]Information as of January 1997.
[b]Securities activities include underwriting, dealing, and brokering in all kinds of securities and all aspects of mutual funds business.
[c]Securities activities fall under the banking activities provisions of Section 1 of the Austrian Banking Act. Hence, such business may be conducted exclusively by a bank.
[d]Holding companies may own the majority of shares in a Greek bank, but there is no specific legal framework referring to such companies.
[e]Only underwriting and custodian services.
[f]Pure holding companies are permitted to incorporate under Luxembourg law, but the statute of a BHC does not exist. This type of company is not submitted to any prudential control by any authority.
[g]Public debt directly in bank and stock exchange in bank subsidiary.

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not because it is the most efficient way to integrate particular activities but because it is, for example, the best organizational structure for extracting rents.

Banks' Securities Activities in the United States

Throughout U.S. history, the conglomerate models that banks have chosen for integrating commercial banking with securities activities have been greatly influenced by regulations, in particular the Glass-Steagall Act.

Before the Glass-Steagall Act

The National Banking Act of 1864 allowed national banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, . . . and other evidences of debt; by receiving deposits; . . . by loaning money on personal security." After the enactment of that act, national banks were at a disadvantage with respect to trust companies and state-chartered banks because they could not offer trust services and their ability to offer securities services was very limited.[3]

The Federal Reserve Act of 1913 reduced that disadvantage by authorizing national banks to offer trust services through an in-house department, but their ability to offer investment banking services directly remained very limited until the enactment of the McFadden Act in 1927. Throughout that period, national banks were not allowed to invest in or deal in stocks. They were, however, allowed to invest in U.S. government obligations, and despite not being explicitly allowed to underwrite and deal in debt securities, other than those of the U.S. government, there is evidence that they did conduct these activities under the "incidental powers" clause. In 1927, with the McFadden Act, national banks were allowed to underwrite and deal in "investment securities" that evidenced the issuing party's indebtedness and the OCC was given the authority to indicate the securities meeting that definition.

Most national banks entered the securities business by establishing an in-house department. But, as investment banking became more important, particularly in the years following World War I, and as competition from less regulated trust companies and state-chartered banks increased, they sought ways to compete with these institutions on an equal footing. They started developing separately capitalized

[3]For a detailed analysis of national banks' securities powers, see Peach (1941). For a discussion of commercial banks' trust and securities services prior to Glass-Steagall, see White (1984).

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securities units. These units were generally chartered under state corporation laws rather than under state banking or trust company laws. As a result, banks could engage in any type of financial service not covered by banking and trust laws, and they could do so without being subject to capital regulation and supervision. In addition, they were free to operate offices throughout their home states and across state lines.

The ability of securities units to operate multiple offices was very attractive to both state and national banks, but particularly to the latter. At that time, state regulations prohibited state banks from branching across state lines and some states even limited intrastate branching. National banks' branching powers began to be defined only in 1927 with the McFadden Act.[4] They were, however, made identical to those of the local banks in the states in which they were located only in 1933 with the Banking Act.

Securities units were generally operated so as to convey the impression that they were very close to their sponsor banks. Their names resembled these banks' names; their main offices tended to be located in the same building as their sponsors' main offices; they frequently benefited from advertising campaigns by their sponsor banks and received loans from them.[5]

Securities units were legally organized so that their sponsor banks controlled their capital. Banking firms generally chose one of the following three organizational forms to integrate their banks with their securities units. In the most common form, the bank's shareholders received a pro rata interest in the stock of the securities unit. Under this arrangement, the shares of the two entities typically were printed on the same certificate, making it impossible to transfer the shares of one entity without transferring the shares of the other. The second organizational form corresponds to the bank parent model. National banks could not promote this organizational structure because they did not have the power to own stock, but trust companies and state-

[4]The McFadden Act gave national banks the same right as local state banks to branch within the cities in which they were located. Soon after 1927, however, states began allowing state banks to branch beyond their home cities, thus putting national banks at a disadvantage. The Banking Act of 1933 ended this disadvantage. For a discussion of the branching regulations, see Pollard et al. (1988).

[5]Banks were not allowed to lend any single borrower, including their securities units, more than 10 percent of their capital, but on many occasions they went beyond this limit by developing chain units and lending the maximum to each unit. Section 23A of the Banking Act of 1933 closed that loophole by limiting loans to all affiliates to 20 percent of the bank's capital.

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chartered banks could do so in some states. The third organizational form corresponds to the holding company model.

The number of national and state banks engaged in the securities business (directly or through separate units) increased steadily from 1923 to the end of the 1920s, at which time it started to decline (Table 2). Throughout the entire 1923–33 period, and particularly at the beginning of the 1920s, there were significantly more state banks offering securities services than national banks. However, because state banks then outnumbered national banks by more than two to one, the proportion of national banks engaged in the securities business was slightly higher than that of state banks.

Two aspects revealed by Table 2 are of particular relevance to the subject of this paper. First, throughout the entire 1923–33 period, there were always more banks (national and state) offering securities services through an in-house department than through a separate unit. With time, however, that difference decreased. Second, the proportion of state banks that chose to offer securities services through an in-house department was always significantly larger than the corresponding proportion of national banks, a difference that may be related to disparities in the securities powers and branching capabilities of these banks.

Table 2 also seems to indicate that the McFadden Act did not significantly affect the organizational structure preferred by banks to integrate banking with securities services. In the case of state banks, this is explained by the fact that the act had no direct influence on their securities and branching powers. The MacFadden Act did, however, increase the incentive for national banks to bring their securities operations into a department inside the bank because, as noted above, it clarified their securities powers and gave them branching capabilities similar to those of the state banks where they were located.[6] Nonetheless, it is possible that these incentives were not strong enough to compensate national banks for the limitations that they continued to face when offering securities services in-house. For example, unlike state banks, national banks were still not allowed to underwrite and deal in equities in-house. They could, however, offer these services through separate securities units, which also had the advantage of being able to operate across state lines.

An alternative explanation is that banks preferred to offer securities services through separate units because of the advantages associated

[6]Peach (1941) and Mote and Kaufman (1989) argue that the McFadden Act mainly gave national banks legal coverage for the securities activities they were already conducting rather than giving them new securities powers.

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TABLE 2

BANKS ENGAGED IN THE SECURITIES BUSINESS DURING THE 1923–33 PERIOD

	National Banks				State Banks			
		Engaged in the Securities Business				Engaged in the Securities Business		
Year	Total[a]	Total[b]	Directly[c]	Through sep. units[c]	Total[a]	Total[b]	Directly[c]	Through sep. units[c]
1923	8,179	95	78	17	21,326	219	210	9
	(27.7)	(1.2)	(82.1)	(17.9)	(72.3)	(1.0)	(95.9)	(4.1)
1925	8,048	145	112	33	20,209	268	254	14
	(28.5)	(1.8)	(77.2)	(22.8)	(71.5)	(1.3)	(94.8)	(5.2)
1927	7,759	181	121	60	18,657	312	290	22
	(29.4)	(2.3)	(66.9)	(33.2)	(70.6)	(1.7)	(93.0)	(7.1)
1929	7,403	235	151	84	17,230	356	308	48
	(30.1)	(3.2)	(64.3)	(35.7)	(69.9)	(2.1)	(86.5)	(13.5)
1931	6,368	237	123	114	13,602	288	230	58
	(31.9)	(3.7)	(51.9)	(48.1)	(68.1)	(2.1)	(79.9)	(20.1)
1933	5,154	178	102	76	9,861	201	169	32
	(34.3)	(3.5)	(57.3)	(42.7)	(65.7)	(2.0)	(84.1)	(15.9)

SOURCES: Board of Governors (1943: 16) for the total number of national and state banks. Peach (1941: 83) for all information on banks involved in the securities business. The total number of state banks includes state-chartered and mutual savings banks. The number of state banks involved in securities activities includes state-chartered banks, savings, and loan and trust companies.

[a]Figures in parentheses indicate the percentage of all banks that had a national and a state charter respectively.

[b]Figures in parentheses indicate the percentage of banks with the corresponding charter that were engaged in securities business.

[c]Figures in parentheses indicate the percentages of banks with the corresponding charter that were engaged in securities business directly and through separate units respectively.

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with corporate separateness. A complete explanation of the banks' choices would require, in addition to the number of banks and securities units engaged in securities services, data on the financial services offered by each of them and information on the organizational structure, including the operational separateness, that they adopted to operate the securities unit. Such data, however, are either very limited or nonexistent.[7]

The Glass-Steagall Act

The coincident involvement of banking conglomerates in the securities business with the securities market boom in the 1920s and the coincident wave of bank failures with the stock market collapse in 1929 led many to believe that securities activities were an important cause of the banking industry's collapse. This belief, along with accusations that banks had exploited conflicts of interest related to their securities activities, led to Congressional hearings, which culminated in the enactment of the Glass-Steagall Act.

Despite their influential role in passing the Glass-Steagall Act, the Pecora hearings provided no solid support for concluding either that securities activities were to be blamed for the bank failures or that the abuses revealed in some banks' practices were common to the industry.[8] Instead, they relied on anecdotal evidence, most of it associated with the practices of two banking conglomerates, the National City Bank of New York and the Chase National Bank, and their securities units, the National City Company and the Chase Securities Corporation respectively.

The Banking Act of 1933 revoked the securities powers granted by the McFadden Act and severely restricted member banks' ability to engage directly in securities activities and to affiliate with entities that were primarily engaged in such activities. Sections 16, 20, 21, and 32 of the Banking Act became known as the Glass-Steagall Act. Section 16 limits national banks' investment banking activities to three areas: acting as agents, limited purchase for their own account of certain securities as defined by OCC regulations, and dealing in some govern-

[7]Two studies of the period before Glass-Steagall produce opposite results on the importance of legal separateness for reducing conflicts of interest. Puri (1996) finds that underwriting securities in-house did not lead to more conflicts of interest than doing so in a separate unit. Kroszner and Rajan (1997) find that underwriting securities in a separate unit was helpful in reducing conflicts of interest.

[8]For an analysis of the events that culminated in the enactment of Glass-Steagall, see Carosso (1970), Perkins (1971), and Benston (1990).

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ment securities.[9] Section 20 prohibits member banks from affiliating with entities that are "principally engaged" in investment banking activities. Section 21 makes it illegal for entities that are engaged in investment banking to accept deposits, except as permitted by Section 16.[10] Finally, Section 32 prohibits interlocking directorates and certain other relationships between member banks and entities that are "principally engaged" in investment banking, except for the limited exemptions allowed by the Fed.[11]

After the Glass-Steagall Act

The Bank Holding Company Act of 1956 and its subsequent amendments did not impose further restrictions on the permissible securities activities of banking conglomerates. They did, however, close a loophole in the Banking Act of 1933. According to the Banking Act, a BHC could not obtain permission from the Fed to vote the shares of a bank subsidiary unless it agreed to divest itself within five years of any interest in a company that was "engaged principally" in investment banking activities not allowed to banks (Pollard et al. 1988). Thus, as long as BHCs did not vote their bank-subsidiary shares, they were not subject to the divestiture requirement. The BHC Act closed this loophole by prohibiting BHCs from owning shares in nonbank corporations other than those engaged in approved banking-related activities.[12] The Fed was given the authority to allow BHCs to engage in nonbanking activities other than those explicitly permitted.[13]

In the decades that followed the enactment of the Glass-Steagall Act, it appears that both commercial and investment banks were willing to accept the separation of the two industries. In the 1960s, however, both sides began attempting to expand their activities into

[9]For a summary of the securities in which national banks are allowed to invest for their own account, see Pollard et al. (1988). Section 16 restrictions were extended to state member banks by 12 USC Section 355.

[10]One implication of Section 21 was to extend the prohibitions of Section 16 to state nonmember banks. Note, however, that these banks were free to affiliate with investment banking firms.

[11]The firewalls introduced by Section 32 to separate a bank from its nonbank affiliates were complemented with the firewalls introduced by Section 23A. This set of firewalls was further extended in 1987 by Section 23B of the Federal Reserve Act (Blair 1994, Walter 1996).

[12]The act created another loophole because it defined a BHC as "any company which directly or indirectly owns, controls, or holds with power to vote, 25 per centum or more of the voting shares of each of two or more banks." The 1970 Amendment to the BHC Act extended that definition to companies that controlled one bank.

[13]The 1970 Amendment to the BHC Act required these activities to be "closely related to banking" and the benefits from their provision by BHCs to outweigh the expected costs of such provision to the economy.

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each other's strongholds. These attempts put pressure on the regulatory agencies to change some of the regulations under their control. The Fed, for example, started allowing BHCs to conduct through their so-called Section 20 subsidiaries some "ineligible" activities, that is, activities prohibited to the banks themselves by Section 16 of the Glass-Steagall Act, such as underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer receivables. To ensure that these subsidiaries were not "principally engaged" in the securities business and thus met Glass-Steagall's requirements, the Fed limited the revenue generated by "ineligible" activities to 5 percent of the subsidiary's total revenue and imposed a set of firewalls between them and the banks that were part of the same holding company. The revenue limit was then twice increased and it now stands at 25 percent. The set of permissible activities was also expanded to include other activities such as the underwriting of corporate bonds and equities, provided that some more stringent firewalls were set up.[14]

Like the Fed, the OCC also expanded national banks' securities powers over the years. It did so under the "incidental powers" clause of the Banking Act of 1864 and on the authority granted by Section 16 of the Glass-Steagall Act. More recently the OCC announced that it would consider national banks' applications to offer a wider range of securities services through their subsidiaries provided that they observe some conditions. They will have to be well capitalized, their equity investment in these subsidiaries may not count toward their capital requirements and their transactions with the subsidiaries will be subject to certain restrictions.

Finally, the FDIC ruled in 1984 that it would allow the banks it oversees, insured nonmember banks, to offer securities services, including underwriting and dealing in corporate securities, through a "bona fide" subsidiary. The subsidiary, however, would have to be distinct and physically separate from the parent bank, and its transactions with that bank would be subject to some restrictions. In 1987, the FDIC amended that regulation, easing the operational separation between the bank and its securities subsidiary (Pollard et al. 1988).[15]

The Location of the Securities Unit in the Conglomerate

This section discusses the potential impact of different locations of the securities unit in a banking conglomerate. It starts with an outline

[14]For a detailed list of the firewalls, see GAO (1995).

[15]For the list of firewalls that the FDIC demands from banks with "bona fide" subsidiaries, see GAO (1995).

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of the potential advantages and disadvantages of corporate separateness and then compares the organizational models usually adopted to implement corporate separateness. The section ends with a discussion of whether the location of the securities unit in a banking conglomerate should be subject to regulation.

Advantages and Disadvantages of Corporate Separateness

Corporate separateness is determined by legal separateness and by operational separateness. Legal separateness leads to the development of separately capitalized units in the conglomerate. Each unit usually has its own management team and its own accounting records and it offers its own products. Furthermore, limited liability protects each unit's shareholders from losses in the event of failure of any other unit of the conglomerate. Operational separateness limits the joint management of the separate units that are part of a conglomerate. It usually results from restrictions on the exchange of information, personnel, or other inputs among the different units.

With respect to banking conglomerates, corporate separateness between banking and securities units is frequently believed to be a source of important advantages. First, because it insulates banks (and through this the safety net and the taxpayers) from the risks in their conglomerates' securities activities. This advantage stems from the perception that securities activities are riskier than traditional banking. Therefore, if banks were to engage in securities activities through an in-house department, they would increase their risk of failure and, consequently, expand the liabilities of the safety net.

Second, because it limits the competitive advantage resulting from the subsidy said to benefit the institutions with access to the safety net. Accordingly, if banks were allowed to offer securities services in-house, the safety net coverage would be extended to these activities and banks would have a competitive advantage over securities firms because they would be able to cross-subsidize their securities operations.

Third, because it reduces potential conflicts of interest that can emerge with the simultaneous provision of banking and securities services. Separateness makes it possible to implement mechanisms, such as compensation schemes for each unit's management team, aimed at reducing the incentives to exploit conflicts (Saunders 1985), and it permits the introduction of firewalls explicitly designed to limit management's ability to exploit conflicts.

Finally, corporate separateness is said to be beneficial because it facilitates the regulation and supervision of banking conglomerates. Requiring banking and securities activities to be conducted by separate

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units keeps each of these units simpler and thus easier to supervise, and it facilitates the adoption of functional regulations, considered to be easier to implement than institutional regulations (Herring and Santomero 1990). Furthermore, it allows banks to be regulated differently from securities firms, which is said to be important because of differences in the types of risk faced by the two entities and because it levels the playing field in a system where banking conglomerates coexist with independent securities firms (Ferrarini 1995).

Despite all these potential advantages, corporate separateness continues to be questioned largely because the market generally does not perceive the units of a conglomerate to be independent, even though they are legally and operationally separated from each other. Several reasons are usually cited to justify the market's perception. First, there are strong incentives to manage a conglomerate as an integrated entity (in order, for example, to exploit scope economies) rather than as a portfolio of independent firms.[16]

Second, conglomerates have an incentive to protect their member units from bankruptcy, even if it is necessary for them to go beyond their equity investment in the financially distressed unit.[17] This incentive results from the conglomerate's interest, for example, in protecting the market's assessment of it, in preserving the reputation of its management (Wall 1984), and in shielding the other units from any potential contagion effects resulting from the failure of a member unit.

Third, the market may not view the units in a conglomerate as being independent of each other because the courts may "pierce the corporate veil." Limited liability does not generally give the creditors of one unit a claim on the assets of another, legally separated unit of the conglomerate. However, there are exceptions to this rule. For example, in a banking conglomerate, if the securities unit misled its creditors into thinking that they were dealing with the bank, then under certain circumstances the courts may hold the bank liable for the debts of the securities unit.[18]

Finally, the market may perceive the units of a conglomerate as not being independent if the conglomerate places more emphasis on its consolidated accounts than on the separate accounts of its units. That perception may also result from the practices of the regulatory

[16]Studies of the management of BHCs in the United States generally yield examples of policies that are centralized at the holding company level (see Cornyn et al. 1986).

[17]For examples of BHCs helping financially troubled nonbanking units, see FDIC (1987) and Cornyn et al. (1986).

[18]For other circumstances that can lead courts to "pierce the corporate veil," see Black, Miller, and Posner (1978) and Thompson (1991).

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agencies in charge of overseeing the banks that are part of conglomerates, particularly if they choose to oversee the financial affairs of the nonbanking units in the conglomerate and those of the entire conglomerate.

Besides being questioned on all these grounds, corporate separateness is also blamed for some problems. First, because it forces the adoption of a more expensive organizational structure (firms must develop and operate an additional separate unit) and because it reduces the scope economies, particularly those on the production side.

Second, because it increases the agency problems arising from the separation of ownership from control. These problems are frequently associated with differences between shareholders' objectives and managers' objectives. Corporate separateness is prone to increase such problems, because it separates control and introduces one additional management team in the conglomerate.

Third, because it may be the source of conflicts of interest. For example, if the banking unit's capital and the securities unit's capital are not owned ratably by the same shareholders, then there will be opportunities, such as through the transference of assets between the two units, to favor one group of shareholders at the expense of the other (Edwards 1979, Saunders 1985).

Finally, corporate separateness is also blamed for giving conglomerates an incentive to move some operations from banks to securities units, leading to a reduction in banks' asset base. The conglomerate may find it advantageous to move some activities which may be profitable and of a low-risk nature from the bank to the securities unit because, for example, of differences in the regulation and supervision of its banking and securities units (Eisenbeis 1983).[19]

The Bank Parent Model versus the Holding Company Model

Some of the advantages and disadvantages of corporate separateness, such as the potential reduction in conflicts of interest that may emerge from the combination of commercial and investment banking, the ability to implement functional regulations and the reduction in scope economies, do not seem to be greatly affected by the conglomerate model adopted to implement the separation. Others, however, do appear to be dependent on that model.

[19]The "ineligible" activities revenue limit has given BHCs an incentive to move "eligible" activities from their banking subsidiaries to their securities subsidiaries in order to create a base of eligible revenue.

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The bank parent model and the holding company model remain the two organizational structures most frequently used to separate banks from securities units within conglomerates. As discussed above, the critical differences between these models derive from the fact that in the former there is a direct relationship between the bank and the securities unit (this unit's capital is an investment of the bank) while in the latter the relationship is only indirect (the securities unit's capital is an investment of the holding company). As a result of that difference, it is usually argued that the holding company model performs better than the bank parent model in the following respects. It provides a better insulation for the bank from problems that may emerge in the securities unit and it gives the bank less incentive to bail out the securities unit, since it is a sister affiliate rather than a directly owned subsidiary. In addition, the model is praised for facilitating the resolution of a bank failure because the capital of the securities unit is an asset of the holding company, not of the bank. As a consequence, if the bank becomes insolvent, such assets need not be considered in the failure resolution procedure.

In other respects, however, it is argued that the bank parent model performs better than the holding company model. It is less expensive to develop and operate because it does not require an additional company, the holding company. It gives the bank more control over the profits of the securities unit because these can leave the conglomerate as profits only through the bank, while in the holding company model they can sidestep the bank and leave through the holding company. In addition, it increases the pool of assets that bank creditors can claim in case the bank gets into financial trouble, thus reducing the bank's incentive to move assets to the securities unit in order to shield them from its creditors. Bank creditors can claim the investment in the securities unit if the conglomerate is organized on the bank parent model, but they cannot do so if the conglomerate is organized on the holding company model.[20]

A final subject of debate on how the holding company model compares to the bank parent model relates to banks' ability to transfer the subsidy they are said to receive from having access to the safety net to the securities units in their conglomerates. Leaving aside the

[20]Regulators in the United States have tried to replicate that claim structure in the holding company model through the "source of strength" doctrine, but it remains unclear whether that doctrine can be legally enforced. The first attempt to apply it was not successful. It happened in 1987, when Hawkeye Bancorporation refused to comply with the Federal Reserve's order to inject $1.2 million in capital into a failing bank subsidiary. The Fed reacted to the refusal by charging Hawkeye with unsafe and unsound practices, but subsequently withdrew that complaint (FDIC 1987).

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question of whether such a subsidy exists and how large it is, there are at least three important channels that banks could use to transfer it to the securities units.[21] First, banks can transfer the subsidy through credit extensions or the exchange of information or the purchase of assets and services from the securities units in their conglomerates on terms that favor these units. Given that banks' transactions with the securities units in their conglomerates can be regulated in the same way irrespective of whether the organizational structure follows the bank parent model or the holding company model, there seems to be no significant difference between the two models with regard to banks' ability to transfer the subsidy through that channel.

Second, banks can transfer the subsidy through capital infusions into the securities units on terms that favor the latter. In the holding company model, it is difficult for banks to use that channel. The capital of the securities unit is an investment of the holding company and not of the bank and there are restrictions on the dividends that a bank can pay to its holding company. In the bank parent model, the ability to use that channel can also be blocked by requiring that the bank's investment in its securities subsidiary be subtracted from the bank's capital for the purposes of meeting the prudential capital requirements.

The last important channel through which the safety net subsidy can be transferred to securities units relates to the market's perception of the relationship between these units and the banks in the conglomerates. The stronger the perception that these are integrated organizations rather than portfolios of independent firms, the higher the chances that the subsidy will be transferred. That perception depends on some factors that affect both organizational models equally, such as the practices of supervisory agencies. It also depends on other factors that vary with the model, namely, how close the bank is to the securities unit in its conglomerate. As discussed above, the direct relationship between the bank and the securities subsidiary that exists in a bank parent model may lead to a stronger market perception of integration than that associated with the holding company model, where the relationship between the two units is only indirect. If that is the case, then the likelihood of a transfer of the subsidy through that channel may be higher under a bank parent model than under a bank holding company model.

[21]For a discussion of the safety net subsidy, see Whalen (1996), Helfer (1997), and Greenspan (1997).

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Should the Location of the Securities Unit Be Regulated?

Economic theory suggests that in the absence of imperfections, such as asymmetries of information, and in the absence of other distortions, such as regulations, the "invisible hand" of the market will promote the most efficient organizations. Deviations from that setting, however, may lead to the development and survival of the "fattest" rather than the "fittest" organizations. For this reason, the burden of proof should be on those who propose restrictions that will interfere with the normal functioning of market forces.

In making the decision about whether to regulate the location of the securities unit within a banking conglomerate, one needs to consider the reasons why banks exist (the provision of liquidity and the performance of monitoring services); the problems associated with these intermediaries (being subject to runs); the devices most frequently adopted to address these problems (the safety net); and the impact of such regulation on the potential advantages and disadvantages of combining commercial with investment banking (scope economies, risk considerations, and conflicts of interest).

Were it not for the distortions arising from the safety net, in a competitive market a bank would choose the most appropriate conglomerate model to integrate traditional commercial banking activities with securities services by comparing the advantages and disadvantages of offering securities services in-house with those resulting from offering them through a separately capitalized unit. Because these effects vary with the securities activities and with factors intrinsic to each bank (such as reputation), some banks would offer their securities services through an in-house department and others would choose to conduct the securities business in a separate unit, under either a bank parent model or a holding company model. Under these circumstances there does not seem to be any fundamental justification for limiting the bank's choice of where to locate its securities operations.

Do the distortions created by the safety net justify a regulation requiring securities activities to be housed outside the bank? The arguments reviewed here, together with evidence on the predominant conglomerate models used outside the United States, make a compelling case for answering that question with a qualified "no." Correcting the distortions at their source (for example, ending the too-big-to-fail policy, requiring market-value accounting, introducing more risk-sensitive insurance premiums and capital requirements and adopting a prompt corrective action procedure) and allowing banks to choose the conglomerate model they find most efficient appears to be a more appropriate policy than maintaining the distortions from the safety

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net and using them to justify the introduction of another layer of distortions, such as those that would result from a regulation requiring corporate separateness.

That proposal would give banks the opportunity to explore the advantages of the various organizational models which, judging from the diversity of their choices elsewhere and in the United States before Glass-Steagall, they seem to value. The alternative of leaving the distortions of the safety net in place and relying on corporate separateness to confine the problems they cause limits the synergies of combining the two activities and gives banks an insulation that is more apparent than real.

A regulation requiring corporate separateness limits the choices of all banks alike, regardless of pertinent factors that are specific to each bank and that influence their risk-taking incentives. In addition, such a regulation introduces costs, some of which increase with the degree of separateness imposed. Given that corporate separateness is the relevant concept, not legal separateness per se, this creates a dilemma. The stronger the separateness imposed, the stronger the insulation it provides the banking unit but the greater the associated costs. At the very extreme, if absolute separateness is imposed, nothing is to be gained from allowing the combination of activities. The dilemma is further complicated by the limitations of corporate separateness, particularly those resulting from the fragility of the firewalls when they are most needed, that is, in conditions of financial distress.

If, despite these problems, regulators still choose to demand separateness, the question that then arises is whether there are any reasons to justify a regulation requiring either the holding company model or the bank parent model? This is the question at the center of the ongoing debate among the three U.S. banking regulatory agencies. They all support corporate separateness, but while the FDIC and the OCC propose a regulation that gives banks the opportunity to choose between the two conglomerate models, the Fed proposes one that requires them to adopt the holding company model.

Given that neither of these models completely dominates the other, and given that it is possible to design provisions which force each of them to mimic the other with respect to most of the relevant dimensions, there does not appear to be a strong justification for requiring one rather than the other. To force banking conglomerates to adopt either of these two models would be to restrict their choices even further, thus exacerbating some of the problems introduced by separateness, and to introduce a regulatory framework that already lags behind the market, thus limiting banks' ability to compete with other intermediaries that are evolving in the financial markets.

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Conclusion

One issue that has been raised in connection with the introduction of a regulation allowing banks to choose between the bank parent model and the holding company model has to do with its potential impact on the portion of the banking industry that each agency supervises and regulates. This issue has emerged because the United States has multiple regulatory agencies, each with different powers and responsibilities. Currently, the OCC charters, supervises, and regulates national banks. The FDIC insures deposits at commercial banks, manages the assets and liabilities of insolvent banks, and supervises and regulates state-chartered banks that are not members of the Federal Reserve System. The Fed supervises and regulates state-chartered member banks as well as BHCs and their nonbank subsidiaries.[22] The Fed is also responsible for providing discount-window loans to depository institutions, for overseeing the payment system, and for conducting monetary policy.

The differences in the regulatory agencies' current powers have led many to argue that if banks were given the opportunity to choose between the bank parent model and the holding company model, many would choose the former and this would reduce the share of the banking industry that the Fed oversees to levels that would impair the central bank's ability to fulfill its responsibilities. The Fed, for example, has claimed that it needs a "significant and important role as a bank supervisor" in order to maintain its ability to "manage crises, assure an efficient and safe payment system, and conduct monetary policy" (Greenspan 1997).

The need for the central bank to play a significant regulatory and supervisory role remains an unsettled issue, which has been discussed elsewhere (see Goodhart and Schoenmaker 1993, Haubrich 1996). Assuming, however, that the central bank does need to oversee a certain segment of the banking industry, this creates a problem in systems where the central bank competes with other banking regulatory agencies. The problem is that with free competition among the regulatory agencies there is no guarantee that any of them will be able to retain a certain market share, much less that they will oversee a particular segment of the banking industry. It will therefore be necessary to interfere in that competition in order to guarantee that the central bank maintains the desirable supervisory role. The question then becomes: how can that objective be best achieved?

[22]In addition, the Fed supervises the international activities of U.S. banks and BHCs, and the operations of foreign banks in the United States.

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The supervisory authority of any regulatory agency can be changed by altering its charter. Attempting to maintain an agency's supervisory role through indirect means, such as by requiring banks to adopt a particular conglomerate model just because that agency has the authority to oversee that model, limits competition among agencies and may introduce important distortions. The introduction of a regulation requiring banks to adopt the holding company model if they want to enter the securities business would guarantee the Fed's supervisory authority but would limit both banks' choices and the competition among regulatory agencies. A more appropriate alternative would be to combine a regulation that does not limit banks' choices with regard to organizational model with a change in the regulatory agencies' supervisory authority in such a way as to guarantee the Fed's supervisory role. Like the first proposal, this would limit competition among the agencies, but it has the advantage of allowing banks to choose between the bank parent model and the holding company model.

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Legal Institutions and Abortion Rates in Mississippi

Charles A. Barbour and William F. Shughart II

Since U.S. combat forces left Indochina in 1973, no political, moral, financial, or personal privacy issue has left its mark on the American conscience like the question of legalized abortion. Opinions are divided as on no other topic of public policy debate. The controversy is tendentious, contentious, and sometimes violent. Almost no one is indifferent to the issue of legalized abortion, and the vast majority of individuals who have already formed an opinion stopped listening to arguments from the other side long ago.

Most public opinion polls show the country sharply split on the question of abortion. Pro-abortion forces point to numbers indicating that a majority of Americans favor abortion rights when there is an imminent risk to the mother's health if the baby is carried to term, or in cases of rape or incest. Pro-lifers tout numbers showing a large majority of Americans opposed to "abortion on demand."

But few abortions are in fact performed to save the life of the mother; even fewer are performed to terminate pregnancies resulting from rape or incest. In modern society, the procedure of abortion is simply used to terminate unwanted pregnancies for many women. Bitter opposition to any proposal that would restrict in any way a woman's "right to choose" suggests that this is so. And if many abortion-minded women are in fact searching for an inexpensive way of disposing of an unwanted child—using abortion as a kind of foolproof birth control device—laws that make abortions less costly should

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reduce the number of abortions and, perhaps, the number of unwanted pregnancies as well. (Although the abortion debate focuses exclusively on a woman's decision to terminate an unwanted pregnancy, women can also choose whether or not to risk becoming pregnant in the first place.)

Evidence from the State of Mississippi suggests that legal obstacles to abortion have a dramatic impact on both abortion rates and birth rates. The effects are particularly stunning among white females 15 to 24 years of age. Since laws imposing a 24-hour waiting period before an abortion can be performed and requiring minors to secure the consent of both parents prior to having an abortion went into effect in the early 1990s, abortion rates among that group have dropped by 65 percent. To be sure, some of the decline in Mississippi's abortion rates is due to abortion-minded women traveling to neighboring states with less restrictive abortion laws. But exports cannot explain all of the observed reductions in in-state abortions. Our analysis suggests that abortion rates have fallen because fewer women are choosing to become pregnant and, among those who do, fewer are choosing to have abortions. Hence, if, in President Clinton's words, one wants abortions to be "safe, legal, and rare," laws making them *more* costly are a way of promoting that goal.

Abortion on Demand?

If abortions are cheap, there will be more of them. In many cases, the child who would have been produced by the pregnancy would have burdened the mother unduly. She could be a single college student who finds herself pregnant during her sophomore year. She is no longer dating the father, and is in a very tough spot. The baby would force her to leave college, becoming a single mother without any hope of professional employment in sight. It is less costly to terminate the pregnancy and get on with her life.

She could be a mother of four who has a surprise pregnancy at age 38, and whose next youngest child is 12. She and her husband can finally see the light at the end of the tunnel, and this child would delay her "empty nest" date another 20 years and cause her husband to work until he is well past 65, since he is now 47. The couple may choose not to have the child.

A single mother with three children already. Each of her children has a different father, and she's not entirely sure who they are. She's only going to get another $100 a month in public assistance because of this baby, which will drop to only about $50 or $60 extra after a year or so, and the money never lasts past the 25th of the month as

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it is. She is trying her best to raise her first three children better than she was raised, and this pregnancy may be the straw that breaks the camel's back.

What about the 26-year-old career woman? Let's say she's married without any children. She wants children one day, but this little bundle of joy is a little ahead of schedule. She's up for a promotion at the bank in three months and she knows being pregnant will sink her chances. She must choose between her job and her child.

Adoption is an alternative to abortion, of course, but not one that is much encouraged by current public policies. This option is particularly problematic for minority women owing to the chronic excess supply of adoptable infants in that segment of the market. Such women may choose abortion to avoid condemning their babies to an endless series of foster home placements.[1]

Abortion in Mississippi

Mississippi has never been considered to be a big abortion state. The high water mark in abortions was reached in 1991, when a total of 8,184 abortions were performed there.[2] Some individual clinics in New York City performed more abortions during 1991 than were performed throughout the entire State of Mississippi that year.

Of the 8,184 abortions performed in Mississippi during 1991, 6,142 (or 75 percent of them) were performed on Mississippi residents. Another 1,432 Mississippians had abortions out of state in 1991, yielding a total of 7,574 Mississippi residents who received abortions that year. In addition, approximately 600 women residing out of state had abortions in Mississippi during 1991. This influx of non-Mississippi women is explained by the fact that Mississippi's more restrictive abortion laws (described more fully below) did not become effective until July 1991, while Louisiana's law at the time was more restrictive than Mississippi's, perhaps sending abortion-minded Louisiana women east across the Mississippi River. Jackson, Mississippi, abortion clinics are closer to Louisiana's northeastern parishes than is the nearest Louisiana abortion provider in Shreveport. Also, as just mentioned, for many years it was much easier to get an abortion in Mississippi than in Louisiana, as was reflected in the greater numbers of non-Mississippi residents receiving abortions in Mississippi. No other substantial area of any bordering state is closer to Mississippi's

[1]The role played by the decline of the traditional American orphanage (and the corresponding rise of foster care) on the placement of children in adoptive families is analyzed in Shughart and Chappell (1998).

[2]All of the data reported herein were taken from State of Mississippi (various years).

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abortion clinics. Also, the other states bordering Mississippi (Arkansas, Tennessee, and Alabama) have similar or less restrictive abortion laws than Mississippi has had at any given time since abortion was legalized.

Even though Mississippi has a relatively low number of abortions, abortion rights have been as hotly debated in the state as they have been elsewhere. Mississippi passed an implied consent law during the 1980s, requiring a 24-hour waiting period before an abortion could be performed. The enforcement of this law was held up for approximately five years by a temporary restraining order (TRO) issued by a Reagan-appointed judge. The American Civil Liberties Union claimed this court order to have been the longest standing TRO in the abortion arena until it was finally lifted in 1991. The implied consent law required an abortion provider to offer information on alternatives to abortion to women seeking an abortion. The clinic then had to wait at least 24 hours before the abortion could be performed. The required information could be supplied in the form of a video or a brochure; the patient's questions could be answered by the clinic's receptionist. The patient was not required to watch the tape or to read the brochure.

Also in 1991, the state legislature passed a law requiring minors to receive permission from both parents before having an abortion. This law was not implemented immediately, but took effect on July 1, 1993. Prior to this date, parents were notified of the abortion only after it had been performed. In a family in which a minor pregnant female lives with both of her natural parents, the parental consent law requires both parents to approve of the abortion. If the parents are divorced, permission can be granted by the one having sole custody. If the minor's divorced parents have joint custody, then both parents must consent. If one parent is deceased, or cannot be found after a reasonable search, then the remaining parent can give consent for an abortion unilaterally. Adoptive parents have the same rights as the minor's natural parents. Stepparents have no say in the matter.

Another regulation that has been implemented by the State Health Department's office of licensure redefines what qualifies as an abortion clinic. In this manner, the state appeared to be opening a two-front offensive on abortions in Mississippi. The first two measures—the implied consent law requiring pre-abortion counseling and a 24-hour waiting period; the other requiring parental consent—were directed at women wishing to terminate a pregnancy. The action taken by the State Health Department appears to have a dual purpose. The regulation states that any medical facility that performs 10 or more abortions a year will be considered to be an abortion clinic. As such, any public or private hospital that performs 10 abortions annually will

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no longer be considered a hospital by the state. It will be reclassified as an abortion clinic.

It could be argued that this regulation was enacted as a way of identifying the state's abortion providers in order that proper training of the staff, medical safety, and sanitation concerns could be monitored by the state, and patients' freedom from harassment could be ensured. Since Mississippi Highway Patrolmen are not posted outside those facilities considered to be abortion clinics yet, one could conclude that the state may have had other motives. Abortion proponents claim that this step was taken to threaten local hospitals and obstetrician-gynecologists who may have performed abortions just one or two times a month. Most small town hospitals and doctors would rather that their facilities not be deemed abortion clinics by the state.

A new law, recently enacted by the legislature and signed into law by Governor Fordice, updates the implied consent statute. Under the old law, women seeking abortions needed only to view a video, which they could sleep through if they wished, or take a brochure, which they were not required to read. The new law, which went into effect on July 1, 1996, requires the abortion physician to consult personally with the woman during her first visit to the clinic. The doctor must outline all of the woman's options (carrying the baby to term and keeping the baby; adoption upon the birth of the baby, even going so far as to provide sample adoption contacts; as well as discussing the medical implications if the woman chooses to go through with the abortion). This requirement cannot be fulfilled by a receptionist or even by a registered nurse. The woman must still wait for 24 hours if she chooses to have the abortion. No data are available yet for the months since this new requirement went into effect. However, an employee of New Women's Medical Clinic, Mississippi's largest provider of abortions, stated that this new requirement of the consultation with the doctor has increased the number of women who do not return after the initial visit, compared with the number of women who failed to return after a consultation with the receptionist or being provided with printed material or an informational video.

The Impact of Legal Obstacles on Abortion Rates and Pregnancy Rates

If abortions are made more costly, there will be fewer of them. Abortions, in other words, follow the law of demand. To be sure, the substitute for an abortion is a newborn baby in the maternity ward, and this is not the desired outcome in a large number of cases. But even though the demand for abortions may be less sensitive to price

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than, say, the demand for shoes, we nevertheless expect the number of abortions to fall as their price goes up. Only the magnitude of the effect is in question.

As the data in Table 1 indicate, the number of abortions performed in Mississippi and on Mississippi women who traveled out of state continued to rise through 1991, and has been in decline since. The relative impact that changing mores and changing prices have had upon these numbers is hard to gauge. Surely some portion of both the increase through 1991, and the reduction since, can be attributed to the moral climate as it pertains to the level of acceptance of abortion within a family or community. It is nonetheless clear that, along with other socioeconomic factors that we have not been able to measure, since 1991 Mississippi's abortion regulations have resulted in a reduction of over 56 percent in the number of abortions performed in Mississippi. The numbers of Mississippians receiving abortions have also declined, although not as greatly. The decline in this case was approximately 18 percent.

Additional insights into the effectiveness of Mississippi's abortion laws can be gained by examining the rate of abortions as it relates to live births in various age and race groups. The key events are that, beginning July 1, 1991, all females must wait 24 hours after being counseled by the abortion clinic staff; beginning July 1, 1993, minors must also obtain prior approval from both parents. Table 2 shows changes over time in the abortion rates of white females and nonwhite

TABLE 1

MISSISSIPPI ABORTIONS

Year	Abortions Performed in Mississippi	Abortions Performed on Out-of-State Residents	Mississippi Abortions Performed In-State	Mississippi Abortions Performed Out-of-State	Total Abortions Performed on Mississippians
1988	5,170	787	4,383	1,711	6,094
1989	5,490	929	4,561	1,887	6,448
1990	6,842	1,551	5,291	1,551	6,842
1991	8,184	2,042	6,142	1,432	7,574
1992	7,555	1,760	5,795	1,583	7,378
1993	6,002	1,174	4,828	1,571	6,399
1994	3,979	165	3,814	2,255	6,069
1995	3,563	123	3,440	2,764	6,204

SOURCE: State of Mississippi (various years).

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TABLE 2

ABORTIONS PER 1,000 LIVE BIRTHS, WHITES (W) AND NONWHITES (NW), BY AGE

Year	Total (W/NW)	Less than 15 Years of Age (W/NW)	15–19 Years of Age (W/NW)	20–24 Years of Age (W/NW)	25–29 Years of Age (W/NW)	30–34 Years of Age (W/NW)
1988	118/227	540/285	265/117	108/122	67/120	86/133
1989	121/133	531/228	250/120	120/126	72/124	81/143
1990	149/163	613/292	290/157	152/158	89/150	101/165
1991	178/199	690/287	317/177	189/198	105/197	124/190
1992	158/197	525/286	256/162	181/211	98/195	103/193
1993	114/170	489/243	203/137	123/186	74/162	82/175
1994	65/125	191/157	96/87	73/143	39/131	55/118
1995	59/115	346/156	96/80	60/130	43/134	39/111

SOURCE: State of Mississippi (various years).

females. (These data refer to abortions taking place in the State of Mississippi, including those performed on out-of-state residents.)

It is obvious when Mississippi's parental consent law went into effect. It was July 1, 1993, thereby raising new obstacles to abortion for half of that calendar year. Parental consent was law for all of 1994, as one can tell based on the lower ratio of abortions to live births for women of all ages. It appears that the abortion rate for white females under 15 years of age climbed back up in 1995. However, it should be noted that abortions were relatively constant for nonwhite females under 15 from 1994 to 1995. Live births dropped from 1994 to 1995, possibly due to the by-then common knowledge that abortions would not be so easy to get keeping the pregnancy rate down through a combination of birth control devices and abstinence from sex. It is also noteworthy that the abortion rate for those females aged 15 to 19 remained relatively constant from 1994 to 1995. Also keep in mind that this is a much bigger sample (about 12 times larger) than those females under 15 getting abortions.

The abortion rates for women 20 years of age and older also declined beginning in 1993, but not to the same extent as did those for females younger than 20. This may be due in part to the fact that women in this age group do not need parental consent to receive an abortion.

At least as far as Mississippi is concerned, young (under 20) white females have always had significantly higher ratios of abortions to live births than nonwhite females. A possible explanation for this difference

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can be found in the explosive birth rates of nonwhite females below 20 years of age compared to their white counterparts. Data on live births per 1,000 females indicate that nonwhites under the age of 15 have fertility rates around seven times higher than whites of the same age, and twice as high for women in the 15 to 19 age group. The disparity in birth rates for those under 15 years of age may explain the high rate of abortions for white females. Only 57 white females under the age of 15 became pregnant in 1995, while well over 300 nonwhite females in this age group did. A small (five or so) shift in the number of abortions performed on white females under 15 would cause a tremendous change in the abortion rate because the sample size is so small. On the other hand, the higher abortion rate for white females could be explained by attitudes within their families that make abortion more acceptable as an alternative to carrying the child to term. It is also clear, though, that a large number of the parents of both white and nonwhite females under the age of 15 do not accept the proposition that unwanted pregnancies should be terminated automatically: An abortion rate of 59 per 1,000 live births translates into about three abortions among the 57 white females under the age of 15 who became pregnant in 1995; the corresponding figure for nonwhite females is about 34 abortions out of 300-plus pregnancies.

Abortion rates among white females were about twice as high as those of nonwhite females before parental consent became the law in Mississippi. After the law changed, white females in the 15 to 19 age group saw their ratio of abortions to live births cut by over 65 percent from its peak in 1991. Similarly, nonwhite females, whose abortion rates generally ran around 40 to 50 percent lower than those of whites, also saw a significant drop (of about 50 percent) in the abortion ratio from its 1991 high. This decline kept the abortion rates of nonwhites consistently lower than, albeit now closer to, those of white females.

The bulk of live births and abortions is seen between the ages of 20 and 34. The abortion rate in this age group is interesting, if only for the reason that it differs so much from the corresponding figures for teenagers. Although white females in the 20- to 24-year-old age group had about the same abortion rates as nonwhite females from 1988 through 1991, the ratio of abortions to live births for white females in this group dropped significantly beginning in 1992—so much so that only four years later, the ratio is about half that of nonwhite females, and seems to be holding steady. This dramatic change, which factors in a steep drop in nonwhite abortions in this age group, can be partially attributed to a rise in out-of-state abortions. The abortion clinic in DeSoto County, Mississippi, has closed, forcing

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abortion-minded Northwest Mississippians to travel to nearby Memphis, Tennessee. But a shift to out-of-state abortion providers cannot be the only explanation for this large drop. It could be that these women are avoiding unwanted pregnancies to a greater extent or choosing not to have abortions.[3] Part of the decline can be attributed to Mississippi's right-to-life movement which is very aggressive in white churches.

A similar progression can be observed among 25- to 29- and 30- to 34-year-olds. In both age groups, the abortion rates of white females were about half those of nonwhites. While nonwhite females experienced a drop of 30 to 40 percent in their abortion rates from 1991 to 1995, white females have seen a decline of 60 to 65 percent. Once again, many whites as well as nonwhites are now leaving Mississippi for abortions (compare the 56 percent drop in abortions performed in-state between 1991 and 1995 with the 18 percent decline in abortions performed on Mississippians over the same period). However, as with the 20- to 24-year-old age group, the abortion rates of white Mississippi females 25 years old and older have declined significantly since 1991.

The shift toward out-of-state abortions may continue as in-state abortions decline. Approximately 45 percent of the abortions performed on Mississippians out-of-state take place in Tennessee and Alabama. Both of these states maintain relatively liberal abortion laws in comparison with Mississippi and Louisiana. As evidence of this, over 1,300 Mississippi women had abortions in Alabama and Tennessee during 1995, while no Mississippi women had abortions in Louisiana in either 1994 or 1995. In 1991, 265 women from DeSoto County, Mississippi, had abortions in-state. Not one woman from DeSoto County had an abortion in Mississippi in either 1994 or 1995, though. In Lafayette County, Mississippi (the location of the University of Mississippi's main campus), the number of residents receiving abortions in-state dropped from 82 during 1991 to only six in 1994 and eight in 1995. This decline can be attributed in large part to the aforementioned closing of an abortion clinic in DeSoto County, Mississippi, which borders Shelby County (Memphis), Tennessee. In 1991, there were 250 abortions performed in Mississippi abortion clinics on residents of Forrest County, which is home to the University of Southern Mississippi. In 1995, barely 100 Forrest countians had abortions in Mississippi. Many abortion-minded Forrest County

[3]These conclusions are consistent with the recent findings of Brown and Jewell (1996), who report evidence from the State of Texas supporting an economic model of fertility choice. In particular, they find that the residents of counties with longer travel distances to the nearest abortion provider have lower abortion *and* pregnancy rates.

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women may have traveled to Mobile, Alabama, in 1994 and 1995. At the same time, abortions in the state capital area (Jackson) have remained relatively stable. Perhaps this can be attributed to the state's policy of classifying as an abortion clinic any medical facility performing ten or more abortions per year, thereby reducing the number of facilities willing to provide them.

The state now has three abortion clinics, two in Jackson and one on the Gulf Coast. The cost of traveling to these locations may explain the steep drop in abortions in northern Mississippi counties other than DeSoto and Lafayette. Abortion rates in many Delta (west central Mississippi) counties have declined substantially, while the reductions have been smaller in counties in close proximity to Jackson or the Coast. Many eastern Mississippi counties have also witnessed large drops in in-state abortions. However, it is clear that many abortion-minded east Mississippi women are now traveling to Tuscaloosa or Birmingham, Alabama, to have the procedure performed.

Mississippi's Abortion Future

The law requiring the abortion doctor to consult personally with the abortion patient 24 hours before an abortion can take place has just gone into effect. The initial report from the New Woman's Medical Clinic is consistent with the hypothesis that obstacles to abortion reduce the number of women who choose that option. However, if more and more women fail to return for their abortions after the initial consultation, the clinics may make adjustments to provide a calming atmosphere where a woman will feel comfortable with the doctor personally and with her decision to terminate her pregnancy. Obviously, some clinics will do better jobs of this than others. It remains to be seen whether the consultation requirement will cause the number of abortions performed in Mississippi to decline further.

The State of Mississippi has not outlawed abortion, but it has made it more costly to get one. These actions have clearly placed a burden on abortion-minded Mississippi women. But those women who are resolute in their desires to have abortions can wait a day, or travel out of state to terminate their unwanted pregnancies. If Tennessee or Alabama impose their own abortion restrictions, it will obviously make it even harder for some Mississippi women to get an abortion.

The important point, though, is that the placing of relatively minor obstacles in the path of abortion-minded women seems to have dramatic effects in reducing abortion rates. One interpretation of the evidence from Mississippi is that many abortions are in fact performed as matters of expedience. Given the chance to reconsider their deci-

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sion, large numbers of women choose to carry their babies to term. What is perhaps more important is that the evidence also seems to suggest that restrictions on abortion reduce the number of women who become pregnant in the first place. Far from interfering with a woman's right to choose, obstacles to abortion help shift that choice back to the conceptual event that creates the life that low-cost access to abortion places at risk.

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China's Future: Market Socialism or Market Taoism?

James A. Dorn

> Though my heart be left of centre, I have always known that the only economic system that works is a market economy, in which everything belongs to someone—which means that someone is responsible for everything. It is a system in which complete independence and plurality of economic entities exist within a legal framework, and its workings are guided chiefly by the laws of the marketplace. This is the only natural economy, the only kind that makes sense, the only one that can lead to prosperity, because it is the only one that reflects the nature of life itself.
>
> —Václav Havel
> *Summer Meditations*

China's Grand Illusion

China's goal of building a "socialist market economy" is a grand illusion. The market and its supporting institutions, notably private property and the rule of law, cannot be grafted onto socialism. Markets are based on voluntary exchange; socialism destroys the spontaneous nature of markets and substitutes government control for individual responsibility. Market socialism, even with "Chinese characteristics," is an unnatural and artificial system which, like the Yugoslav experiment with workers' management, is destined to fail.

Without widespread private property, economic decisions—especially investment decisions—will continue to be political decisions and be subject to the corrupting influence of government power. The recent chaos in East Asian currency markets attests to the destructive nature of state-led development policy fueled by "crony capitalism." Government-run banks in South Korea, for example, based their

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lending practices more on political factors than on sound economic criteria (Yoon 1998). Preferential loans to Korea's large conglomerates, the *chaebols*, at below-market interest rates may have maintained the cozy relations among business leaders, bankers, and politicians, but they also laid the basis for a boom-and-bust business cycle. Creating Korean-style conglomerates in China would be a costly error. Letting natural market forces weed out inefficient firms would be a step in the right direction.[1]

China's state-owned enterprises (SOEs) and banks do not need partial reform; they need to be divorced from the state and subjected to the full force of market competition. Turning to the half-measure of market socialism will only prolong the costs of transition to a real market system and continue to politicize economic life. What China needs are "free private markets," not regulated socialist markets (Friedman 1990: 5). Privatization of SOEs would create real owners who were responsible for their firms' performance and had an incentive to maximize profits by hiring efficient managers and producing what consumers wanted.

The absence of a hard budget constraint for SOEs means that bankruptcy is a hollow threat for most of China's 305,000 state enterprises. And the absence of that threat means SOEs have little incentive to change their inefficient ways. As a result, 50 percent of China's 118,000 state industrial enterprises reported net losses in 1996 (World Bank 1997: 28).[2]

Although China's leaders have been willing to sell off smaller SOEs, they have not embraced the idea of large-scale privatization, for obvious political reasons. Selling off all SOEs would relieve China's massive headache due to the financial drain on the state budget of having to subsidize SOEs, but it would also jeopardize the authority of the Chinese Communist Party. With socialism being the dominant ideology in China, there remain serious obstacles to fostering the market component of market socialism. Turning SOEs into "public" corporations, with the state retaining a controlling interest and restricting the marketability of shares, may be appealing at first sight, but on closer examination can never replicate real markets. As economist G. Warren Nutter (1968: 144) noted 30 years ago when he examined the theoretical case for market socialism, "Markets without divisible and transfer-

[1]As Nicholas Lardy points out, China "ought to be relying on a much more competitive market to drive out inefficient firms and allow some natural consolidation to take place" (quoted in Restall 1997: A22).

[2]The actual state of SOEs could be much worse. Hugo Restall (1997: A22) reported in the *Wall Street Journal*, "State firms are desperately sick: as many as 70 percent are losing money."

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able property rights are a sheer illusion. There can be no competitive behavior, real or simulated, without dispersed power and responsibility." That is why he called the idea of market socialism "a grand illusion."[3]

To "revitalize" SOEs, China has begun to establish large, state-run holding companies, called "state asset operating companies," which are supposed to substitute for real capital markets (Walker 1997: 6). In this setup, the state retains majority ownership, restricts the transferability of "shares," and limits the restructuring process to what is politically acceptable. Thus, politics, not the market, prevails. That approach to SOE reform is akin to the experiment with perestroika in the former Soviet Union: it is a pseudo-reform that tries to dress SOEs in market garb but never really changes the underlying ownership structure from state to private property. Commenting on the Soviet effort to revitalize state enterprises, Alexander Tsypko (1991: 289) wrote,

> It took us five wasted years of perestroika to understand that, essentially, the revitalization of Stalinist socialism is impossible; there is no third way between modern civilization and socialism as it is. The market cannot be combined with . . . public ownership of the means of production. A return to the market is impossible. . .without broad-based privatization.

The same criticism applies to China's experiment with market socialism.

China's state-owned enterprises cannot be revitalized; they have a terminal disease that is eating up China's scarce capital. In 1996, for the first time since 1949, state enterprises as a whole suffered a net loss—"the state received no return for its massive investment in SOEs" (EAAU 1997: 10). SOEs absorb more than 50 percent of state investment funds, employ 66 percent of the urban workforce, but produce less than 30 percent of total output (EAAU 1997: 338). China's leaders should have the courage to go beyond the policy of "grasping the big enterprises and giving a free hand to the small ones" (*zhua da fang xiao*). All SOEs should be candidates for privatization.[4]

[3]Almost 60 years ago, F. A. Hayek ([1940] 1948: 203) observed, "To assume that it is possible to create conditions of full competition without making those who are responsible for the decisions pay for their mistakes seems to be pure illusion."

[4]Fan Gang (1997: 7) argues that China's "bottom-up" approach to reforming small SOEs may also work for medium and large SOEs, but it will take a long time. That approach allows market forces to bring about spontaneous privatization and then, once proven successful, to legalize it at higher levels. Fan points out that de facto privatization of small SOEs began three years before formal government approval. The "bottom-up" approach is politically attractive because politicians do not have to precommit to ownership reform, so they can take credit for success without having to bear the risk of failure.

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Making large SOEs the "pillars" of the national economy by "corporatizing" them, with the government holding all or most of the stock, is a recipe for disaster. That would be market socialism in spades.[5]

From Market Socialism to Market Taoism

China need not be confined to the ideological cage of market socialism by fear of copying Western traditions of market liberalism. The way of the market is universal. The free-market economy is, as Václav Havel (1992: 62) so elegantly stated in the introductory quote, "the only natural economy, the only kind that makes sense, the only one that can lead to prosperity, because it is the only one that reflects the nature of life itself." Since 1978, market liberalization has substantially increased the standard of living of millions of Chinese, and a recent poll showed that many Chinese now believe that "private property is sacred.[6] Today more than 22 million entrepreneurs in China are members of the National Association of Private Entrepreneurs (Pei 1997: 4).

The climate is ripe for further market liberalization in China. At the Communist Party's 15th Congress, in September 1997, President Jiang Zemin stood firmly behind Deng Xiaoping's economic reforms and favored turning SOEs into joint-stock companies. And, at the National People's Congress, in March 1998, Premier Li Peng stated, "The incompatibilities of government institutions to the development of a socialist market economy have become increasingly apparent" (quoted in Mufson 1998: A1). China's new premier, economic pragmatist Zhu Rongji, needs to recognize that the only way to eliminate those incompatibilities is by eliminating socialism and moving toward a free society with limited government, the rule of law, and private ownership. The announcement at the NPC that the size of China's civil service will be cut in half and that at least 11 ministries will be abolished or streamlined is an indication that China may be ready to move in the right direction (Kynge 1998, Mufson 1998). Yet, as long as China confines itself to creating a socialist market economy and restricts economic liberties, the future path of China's market economy will remain unclear.

[5]Hugo Restall (1997: A22) writes, "Most of the state-owned enterprises that have been corporatized under the 1993 Company Law are still run as private fiefdoms by management at the expense of the state banks. As long as the state remains in control, it appears, it is impossible to make a credible break from the old days of subsidies and easy credit. . . . Sooner or later the state will have to face up to the need to relinquish both ownership and control."

[6]Minxin Pei (1998:76) reports, "In a 1993 poll of 5,455 respondents in six provinces, 78 percent agreed with the statement, 'Private property is sacred and must not be violated'."

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In considering what steps to take next, China's leaders should look to their own ancient culture and rediscover the principle of spontaneous order—the central principle of a true market system.[7] In the *Tao Te Ching* (also known as the *Lao Tzu*), written more than 2,000 years before *The Wealth of Nations*, Lao Tzu instructed the sage (ruler) to adopt the principle of noninterference as the best way to achieve happiness and prosperity:

> Administer the empire by engaging in no activity.
> The more taboos and prohibitions there are in the world,
> The poorer the people will be.
> The more laws and orders are made prominent,
> The more thieves and robbers there will be.
> Therefore, the sage [ruler] says:
> I take no action and the people of themselves are transformed.
> I engage in no activity and the people of themselves become prosperous [*Lao Tzu*, 57; Chan 1963: 166–67].

From a public-choice perspective, the foregoing passage implies that the more the state intervenes in everyday life, the more rent seeking and corruption there will be. Alternatively, if people are left alone to pursue their own happiness, a spontaneous market order will arise and allow people to create prosperity for themselves and their country. Like Lao Tzu, China's leaders should realize that corruption stems not from freedom but from freedom being overly constrained by government. As Nobel laureate economist Gary Becker (1996: 75) stated, "Markets grow up spontaneously, they are not organized by governments, they grow on their own. If individuals are given freedom, they will help to develop markets for products that one cannot imagine in advance."

Just as the principle of spontaneous order is central to economic liberalism, the principle of *wu wei* ("nonaction") is fundamental to Taoism. Rulers rule best when they rule least; that is, when they take "no unnatural action."[8] When government is limited, it can help cultivate an environment in which individuals can pursue happiness and practice virtue (*te*). Thus, Lao Tzu writes, "No action is under-

[7]Nobel laureate economist James M. Buchanan (1979: 81–82) has called "the principle of spontaneous order" the "most important central principle in economics." It is the idea that individuals seeking their own gain in a system of private ownership and free markets bring about mutually beneficial exchanges, and that competitively determined prices coordinate economic decisions without central planning. In fact, central planning cannot lead to the market-determined outcome because no one has sufficient information to know that outcome in advance (see Hayek 1945, Lavoie 1990).

[8]Wing-Tsit Chan (1963: 136) notes that the principle of *wu wei* does not mean " 'inactivity' but rather 'taking no action that is contrary to Nature'." In essence, "*wu wei* . . . is the embodiment of suppleness, simplicity, and freedom" (Smith 1991: 208).

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taken, and yet nothing is left undone. An empire is often brought to order by having no activity" (*Lao Tzu*, 48; Chan 1963: 162).

Like water, the market is resilient and will seek its natural course—a course that will be smoother, the wider the path the market can take and the firmer the institutional banks that contain it. The challenge for China is to widen the *free* market and provide the institutional infrastructure necessary to support *private* markets. The solution is to discard market socialism and make the transition to "market Taoism." Or, as Gao Shangquan, vice minister of the State Commission for Restructuring the Economy, recently stated (in Chang 1997: 15), the challenge is to throw SOEs "into the sea of the market economy."

Breaking the Planning Mentality

The collapse of the Soviet Union and the failure of central planning have ended the debate over whether the plan is superior to the market. As Liu Ji (1997), vice president of the Chinese Academy of Social Sciences, recently remarked, "The only people in China who still cling to the idea of central planning are fossilized, dogmatic Marxists." Yet the planning mentality is hard to break—in both the East and the West. It is very tempting for the "best and the brightest" to imagine that they can improve upon the "invisible hand" of the market. But free markets cannot be planned; they emerge spontaneously as consumers' preferences and technology change, and they require well-defined private property rights and freedom of contract.

The incompatibility of government planning and market forces threatens China's future. The vibrancy of the market-driven nonstate sector, which accounts for more than 70 percent of industrial output value, is propelling the People's Republic into the 21st century, but the ossified state sector—driven by state planners—is acting as a drag on development. The "heavy-industry-oriented development strategy," which is reminiscent of the days of Soviet-style central planning, is still ingrained in the collective consciousness of China's ruling elite (Lin et al. 1996: 218). Without free capital markets and widespread private property, investment decisions necessarily become political decisions. Corruption and rent seeking will continue in China as long as economic decisions are government driven instead of market driven. When the government holds interest rates at artificially low levels, politics—not prices—determines who gets scarce capital. People become dependent on government and lose their foresight and freedom. Moreover, one control leads to others, so that once a government departs from free-market principles, it tends to head further down the "road to serfdom" (Hayek 1944; Mises 1980, 1998).

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Piecemeal reform creates tensions: the rigidity of the old planning system is pitted against the resiliency of the market. In China, old institutions are giving way to new ones, but not fast enough to eliminate "institutional incompatibility." As Lin et al. (1996: 226) point out,

> The overall performance of China's gradual approach to transition is remarkable, but China has paid a price. Because the reform of the macro-policy environment, especially interest-rate policy, has lagged behind reforms of the micro-management institution and resource allocation mechanism, institutional arrangements in the economic system have become internally inconsistent. As a result of the institutional incompatibility, rent seeking, investment rush, and inflation have become internalized in the transition process. To mitigate those problems, the government often resorts to traditional administrative measures that cause the economy's dynamic growth to come to a halt and retard institutional development.[9]

If China wishes to continue its rapid economic growth into the next century and end corruption, it must strive for institutions that are consistent with free-market principles and the rule of law. That is why Lin et al. (1996: 226) argue, "It is essential for the continuous growth of the Chinese economy to establish a transparent legal system that protects property rights so as to encourage innovations, technological progress, and domestic as well as foreign investments in China."

The Soviet system failed because it disregarded reality—namely, the reality that the way of the market, not the plan, is most consistent with human nature and, thus, with individual rights to life, liberty, and property. Soviet-style planning destroyed the institutions of property and contract that underpin the free private market and created a rigid economic system that finally collapsed of its own weight. What Soviet citizens witnessed during perestroika and glasnost was "not the organic revitalization of socialism but the withering away of forcibly imposed economic and political structures" (Tsypko 1991: 290). Today, China is also witnessing the "withering away" of the state-controlled economy, but its "political structures" still await fundamental reform.

Ultimately, economic and political reform are inseparable. To depoliticize economic life, China needs constitutional change and new

[9]In 1984, China decentralized the allocation of credit by allowing local branches of the central bank to extend credit directly to SOEs. But interest rates were kept artificially low and the banks simply extended new credits, which led to rapid money growth and inflation. Instead of deregulating interest rates, the government reimposed central rationing of credit and directly controlled investment projects. Thus, the "planned system" returned. China's "boom-and-bust cycle" is a result of not going all the way to a market economy and failing to insulate the banking system from political manipulation. Because interest rates are set at below-market levels, nonprice rationing and rent seeking are rampant in the allocation of credit in China. For a discussion of these points, see Lin et al. (1996: 219–20).

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thinking (*xin si wei*). Chinese scholar Jixuan Hu (1991: 44) writes, "By setting up a minimum group of constraints and letting human creativity work freely, we can create a better society without having to design it in detail. That is not a new idea, it is the idea of law, the idea of a constitution." To accept that idea, however, means to understand and accept the notion of spontaneous order and the principle of nonintervention (*wu wei*) as the basis for economic, social, and political life.

China's leaders and people can turn to the writings of Lao Tzu for guidance. According to noted Chinese philosopher Wing-Tsit Chan (1963: 137), the *Lao Tzu*

> strongly opposes oppressive government. The philosophy of the *Lao Tzu* is not for the hermit, but for the sage-ruler, who does not desert the world but rules it with noninterference. Taoism is therefore not a philosophy of withdrawal. Man is to follow Nature but in doing so he is not eliminated; instead, his nature is fulfilled.

It is in this sense that Lao Tzu writes,

> When the government is non-discriminative and dull,
> The people are contented and generous.
> When the government is searching and discriminative,
> The people are disappointed and contentious [*Lao Tzu*, 58; Chan 1963: 167].

"Lao Tzu Thought," not "Mao Zedong Thought," is the beacon for China's future as a free and prosperous nation. Deng Xiaoping (1987: 189) implicitly recognized Lao Tzu's way of thinking when he said,

> Our greatest success—and it is one we had by no means anticipated—has been the emergence of a large number of enterprises run by villages and townships. They were like a new force that just came into being spontaneously. . . . If the Central Committee made any contribution in this respect, it was only by laying down the correct policy of invigorating the domestic economy. The fact that this policy has had such a favorable result shows that we made a good decision. But this result was not anything that I or any of the other comrades had foreseen; it just came out of the blue.[10]

Although China can return to its own vision of freedom by embracing and extending Lao Tzu's thought, the idea of "market Taoism" can be enhanced by a deeper understanding of classical liberal economic thought and a study of free-market institutions and public choice. In

[10]Kate Xiao Zhou (1996: 4) describes the demise of China's collective farms and the creation of the household responsibility system (*baochan daohu*), with its township and village enterprises (TVEs), as "a spontaneous, unorganized, leaderless, nonideological, apolitical movement."

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breaking the planning mentality, therefore, China can learn both from its own culture and from the West.

The Tao of Adam Smith

In 1776, Adam Smith argued that, if "all systems either of preference or of restraint" were "completely taken away," a "simple system of natural liberty" would evolve "of its own accord." Each individual would then be "left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or group of men," provided "he does not violate the laws of justice" (Smith [1776] 1937: 651).

In Smith's system of natural liberty, the government would no longer have the obligation of overseeing "the industry of private people, and of directing it towards the employments most suitable to the interest of the society"—an obligation "for the proper performance of which no human wisdom or knowledge could ever be sufficient" (Smith 1937: 651).

Government would not disappear under Smith's market-liberal regime, but it would be narrowly limited to three major functions: (1) "the duty of protecting the society from the violence and invasion of other independent societies"; (2) "the duty of protecting, as far as possible, every member of society from the injustice or oppression of every other member of it"; and (3) "the duty of erecting and maintaining certain public works and certain public institutions" (Smith 1937: 651).

In the private free-market system advocated by Smith, people get rich by serving others and respecting their property rights. Thus, the system of natural liberty has both a moral foundation and a practical outcome. Private property and free markets make people responsible and responsive. By allowing individuals the freedom to discover their comparative advantage and to trade, market liberalism has produced great wealth wherever it has been tried. There is no better example than Hong Kong.

The chief architect behind the Hong Kong economic miracle was Sir John Cowperthwaite, a Scot who admired the work of Adam Smith and other classical liberals. As Hong Kong's financial secretary from 1961 to 1971, he constantly challenged attempts to increase the power and scope of government in Hong Kong. Like Smith, he believed that free private markets would keep people alert to new opportunities by quickly penalizing mistakes and rewarding success in the use of society's scarce resources. Sir John understood that no system is perfect

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but that, of all known economic systems, the market price system, with its automatic feedback mechanism, has performed the best:

> In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralized decisions of a government, and certainly the harm is likely to be counteracted faster [quoted in Nancy DeWolf Smith 1997: A14].

The idea that people have a natural tendency to make themselves better off if left alone to pursue their own interests, and the notion that a laissez-faire system will be harmonious if government safeguards persons and property, are the foundation of the West's vision of a market-liberal order, but they are also inherent in the ancient Chinese Taoist vision of a self-regulating order—an order we might properly call "market Taoism" (Dorn 1997).

The Taoist system of natural liberty, like Smith's, is both moral and practical: moral because it is based on virtue and practical because it leads to prosperity. The Chinese puzzle is to discard market socialism and institute "market Taoism" by shrinking the size of the state and expanding the size of the market—and, in the process, to give rebirth to China's civil society.

Market Taoism and China's Civil Society

China's transition from central planning to a market-oriented system since 1978 has been bumpy, but China is moving ahead. Market liberalization has opened China to the outside world, increased opportunities in the nonstate sector, generated new ideas, and energized civil society. That China's civil society has benefited from the end of communal farming, the rise of TVEs, the expansion of foreign trade, and the increased competition from nonstate enterprises should be no surprise. The more economic activity occurs outside the state sector, the more freedom individuals have to pursue their own happiness and lead their own lives. The demand for economic freedom cannot long be separated from the demand for other freedoms.

The market and its supporting institutions follow both formal and informal rules. The informal rules of conduct that underlie the free market, however, are entirely different from the obedience-driven rules of behavior under central planning. Zhang Shuguang (1996: 5), an economist at the Unirule Institute in Beijing, one of China's first private think tanks, writes,

> Mandatory economy and market economy belong to entirely different ideologies and different ethics. . . . Planned economy is based upon some idea of ideal society and beautiful imagination, but

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> compulsory implementation has been its only means of realization. In such a system, [the] individual is but a screw in a machine, which is the state, and loses all its originality and creativeness. The basic ethics required in such a system is obedience. In the market system, which is a result of continuous development of equal exchange and division of labor, the fundamental logic is free choice and equal status of individuals. The corresponding ethics in [the] market system is mutual respect, mutual benefit, and mutual credit.

Understanding those differences is the first step in China's long-march to "market Taoism."

Although China has yet to accept the rule of law, a legal system is emerging and property rights are beginning to be respected. Informal codes of business behavior are being adopted to better serve consumers and to improve the efficiency of exchange. The opening of the legal system is important because it paves the way for the transition from "rule by law" to "rule of law." Marcus Brauchli (1995: A1) of the *Wall Street Journal* writes,

> The state's steel-clad monopoly on the legal process, which makes the courts just another arm of government, is corroding. China's economic liberalization . . . has spawned a parallel legal reform that raises the prospect of rule of, not merely by, law.

Princeton University professor Minxin Pei (1994, 1995) argues that the gradual development of China's legal system toward affording greater protection for persons and property, the growing independence and educational levels of members of the National People's Congress, and the recent experiments with self-government at the grassroots level will help transform China into a more open and democratic society. He points to the upward mobility of ordinary people, occasioned by the deepening of market reform, and to the positive impact of China's "open-door" policy on political norms. In his view, public opinion and knowledge of Western liberal traditions, such as the rule of law, "have set implicit limits on the state's use of power" (Pei 1994: 12).

People are beginning to use the court system to contest government actions that affect their newly won economic liberties. According to Pei (1994: 12), "The number of lawsuits filed by citizens against government officials and agencies for infringements of their civil and property rights has risen sharply, and an official report reveals that citizens have won about 20 percent of these cases."

Anyone who has visited China's booming coastal areas and new urban centers, such as Shishi in the province of Fujian, can see firsthand the transformation of economic life that is occurring every

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day in China and witness the regeneration of civil society.[11] Commenting on China's cultural transformation, Jianying Zha (1995: 202) writes,

> The economic reforms have created new opportunities, new dreams, and to some extent, a new atmosphere and new mindsets. The old control system has weakened in many areas, especially in the spheres of economy and lifestyle. There is a growing sense of increased space for personal freedom.

China has a long way to go, but denying China most-favored-nation trading status or imposing sanctions on China with the hope of advancing human rights, as some in the U.S. Congress have threatened to do, would be a costly mistake. It would isolate China and play into the hands of hard liners who are critical of market liberalization, thereby undermining the prospects for further reform. The best way to advance human rights in China is not to close China off from the civilizing influence of trade, but to continue to open China to the outside world (Dorn 1996). That will be a slow process, no doubt, but the progress made since 1978 should not be underestimated.

In the coastal community of Wenzhou, for example, there are now more than 10,000 private enterprises, and life is vastly different and freer than before liberalization. According to Ma Lei (1998: 6):

> The development of the private sector has fundamentally changed the way residents of Wenzhou look at the world. Traditionally, Chinese peasants lived by the motto, "facing the earth with the back toward the sky." They were tied to their land. Where they were born was, almost always, where they would work and where they would die. Their options were limited in the extreme. In comparison, a child born in Wenzhou now has an endless number of choices. He can decide to work the land or work for an industrial firm or even start his own business. Market forces have broadened the horizons of Wenzhou residents and educated them to the ways of the world. They have learned that in a market economy entrepreneurs frequently fail. But they have also learned that risk taking, when combined with foresight and hard work, can produce significant rewards—a fact that many business owners in Wenzhou appreciate.
>
> Most important, the people of Wenzhou realize that on the market all is harmonious—that one earns his living not through coercion or brute force but by serving others. That realization has produced a climate in which private industry and private organizations—including private schools—can thrive.

[11]For a discussion of China's emerging civil society, see Pei (1997). Kathy Chen (1996) describes the model of development in China's new urban centers, such as Shishi, as "*xiao zhenfu, da shehui*—small government, big society—which advocates less involvement by cash-strapped governments and more by society."

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The Path to China's Future

In the long run, market socialism, like central planning, is bound to fail because it is contrary to human nature. For more than 70 years, various forms of socialism were tried in the Soviet Union—with no success. Why should "market socialism" succeed in China? Adding an adjective to socialism—even if it is "market"—will not cure the institutional inconsistencies in China. As Soviet dissident Vladimir Bukovsky (1987: 127) wrote in *To Choose Freedom*,

> Those of us who have lived under socialism exhibit the once bitten, twice shy syndrome. Perhaps Western socialism is in fact different and will produce different results. . . . The truth of the matter is that the various ideas that seem fresh and innovative to Western specialists have already been tested in the USSR. And if some of those experiments were eventually repudiated, it was not because socialism has been perverted in the USSR, . . . , but because these innovations proved to be utterly unfit for real life. A cruel experiment half a century long has failed to alter human nature.

The "fatal conceit" inherent in the Soviet vision was to think that government planners could run an economy like a machine and achieve long-run prosperity (Hayek 1988). Although China has recognized the error of central planning and has introduced a market system, that system is still half-baked. The question is: Will China move all the way to market liberalism or remain mired in market socialism? Will China jump into the sea of private enterprise or remain suspended in a trancelike state under the illusion that market socialism will solve its problems?

In considering that question, China's leaders would do well to heed the advice of Nien Cheng—who, like many in China, suffered the grave injustices of the Cultural Revolution. She writes (1990: 334),

> China is faced with the choice between socialism and a market system; a mixed system is doomed to failure. The obstacles to China's development can be removed only if China goes all the way toward a private market system with constitutional protection for both economic and civil liberties. China's crisis is a crisis of confidence; the people are in a half-awakened state of mind. The old regime has lost its legitimacy but a new regime has not emerged to fill the vacuum, and there has been no clear commitment to the path of markets and freedom of choice.
>
> To regain consciousness and emerge from the semi-conscious state that now envelops China will take time. But reality requires that China recognize the death of communism. Reality also requires that China embark on thoroughgoing reform or face the prospect of being left behind in the wake of the liberal revolution that is now sweeping the globe.

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China has been willing to experiment with institutional change since 1978 and has made great progress in reducing poverty. Future prosperity, however, will depend on whether China turns away from the artificial path of market socialism and follows the natural path of market liberalism. The market-liberal vision is not new to China; it was inherent in the Taoist doctrine of *wu wei* developed by Lao Tzu and his disciples. China's leaders need only let the Chinese people return to their roots to see the wisdom of letting the spontaneous market process organize economic life, while limiting government to the protection of life, liberty, and property. In that effort, Hong Kong can play an important role by spreading the "tao" of Adam Smith and Sir John Cowperthwaite to all of China—thus allowing the West and the East to meet in one spirit of "market Taoism."

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BOOK REVIEWS

The China Miracle: Development Strategy and Economic Reform
Justin Yifu Lin, Fang Cai, and Zhou Li
Hong Kong: Chinese University Press, 1996, 340 pp.

China has created an economic miracle since its economic reforms began in the late 1970s, becoming the fastest growing economy in the world. Gross domestic product has grown at an average rate of 10 percent annually for the past 18 years, and personal income and living standards have improved significantly. China may become the world's largest economy early next century.

The great success of China's economic reforms has attracted worldwide attention. *The China Miracle* is a book that addresses the following questions: How did China's economic reforms create the miracle? Why has there been such a dramatic difference in China's economic performance since the reforms? Despite the reforms, why is there a "boom-bust" cycle in the Chinese economy? Can China continue its growth? What are the general implications of China's experience for other economies in transition?

The authors of this book have been involved in many of the decision-making processes during China's economic reforms. Combining their first-hand experience and solid training in modern economics, the authors provide new insights into China's economic development strategy and reforms from both theoretical and empirical perspectives.

The main argument of the book is that economic performance and growth depend crucially on the choice of development strategy. The China miracle is the result of China's having chosen the right development strategy—that is, pursuing the economy's comparative advantage and abandoning the "heavy-industry-oriented" or "leap-forward" development strategy adopted during the pre-1979 reform period.

According to the authors, the dream of China's socialist revolution was prosperity for the people and the country. After the People's Republic of China was established in 1949, Chinese leaders chose a leap-forward strategy that required the development of heavy industry, as in the Soviet model, to catch up with Western industrialized countries. However, at

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that time, China was an economy with very scarce capital but abundant labor. To implement the heavy-industry-oriented strategy, the Chinese government had to use a centrally planned economic system that forcefully allocated scarce resources to the heavy-industry sector. At the macro level, the government controlled the prices of credit, hard currency, energy, raw materials, labor, and necessities of life to artificially lower the costs of the development of heavy industry. At the micro level, there was no managerial autonomy. Firms' production decisions were made according to the state plan. Production costs and profits were also controlled by the state. That economic system resulted in a distorted industrial structure with poor incentives and low allocative efficiency.

Comparing experiences in China and other countries, the authors conclude that the leap-forward strategy failed, not only in communist countries like China and the former Soviet Union, but also in India and other noncommunist countries, because it could not accelerate economic development. Indeed, the authors argue that China's stubborn adherence to a heavy-industry-oriented development strategy is the fundamental cause of China's failure to achieve sustained development before 1979.

The authors contrast China's pre-1979 development strategy with the comparative-advantage strategy of development adopted by Japan and the four Asian Tigers—Hong Kong, Taiwan, South Korea, and Singapore. Although the initial economic conditions in those countries were very similar to those in China, they achieved a high and stable level of economic growth during the last few decades by choosing the right development strategy. The authors believe that the main reason for those countries' success is that they had let their own comparative advantages come into full play at each stage of their development.

Chapter 5 provides an overview of China's reform process. The main philosophy behind the reforms was based on the idea of the late leader, Deng Xiaoping: crossing a river by groping one's way from one stone to the next. From 1978 to 1984, China's economic reforms were focused on improving micromanagement institutions to improve the incentive mechanism. Farmers and enterprises were given more autonomy in production and management.

Before the reforms, farmers were under the People's Commune (collective farming) system. They were told what to do, how to do it, and how much they would be paid. The poorly designed payment methods did not reflect each farmer's actual contribution to production. That system seriously hampered incentives for farmers to produce. Farmers' real income hardly increased at all during the commune period. The shortage of agricultural products became a persistent problem.

China's economic reforms started in the rural areas. The household responsibility system replaced the previous system. Land was assigned to each household. After fulfilling its contractual obligations, each household was allowed to retain the remaining output. The system significantly stimulated the farmers' incentives to produce, and, consequently, agricul-

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tural production increased rapidly. The hitherto chronic shortage of agricultural products was over.

A similar reform was extended to urban areas. Enterprises were granted a certain degree of autonomy in production, investment, and income distribution. Enterprise managers and workers then had incentives to increase production and improve the efficiency of resource utilization.

As state-owned enterprises had more autonomy and nonstate enterprises began to emerge, the rigid centrally planned resource-allocation system no longer fit the needs of the economy. In the second phase of reform (1984–91), the main focus was on reforming the planned allocation of resources. A dual-track resource-allocation and price system was adopted. Through this newly established market mechanism, part of the resources flowed to the labor-intensive sectors that had been suppressed under the traditional economic system. As a result, the economic structure improved and the growth rate accelerated.

The reform of micromanagement institutions and the resource-allocation mechanism revitalized enterprises. But unequal competition arising from dual-track factor prices and rent-seeking behavior also created enormous chaos. In the third phase (1992 onward), the reforms were focused on the macro-policy environment, with the goal of establishing a "market-socialist economy."

China's reforms have led to rapid economic growth, improved economic incentives and efficiency, adjustment of the industrial structure, and exploitation of comparative advantage. However, many new problems have emerged along the way.

First, the boom-bust cycle of growth and inflation has been persistent in China's economy. When the government tightens its control of the economy, economic performance is poor (bust). Slowing economic growth prompts the government to loosen its economic policy, including increasing the supply of credit. The economy often responds vigorously and grows at a faster pace (boom). But then, institutional arrangements inside the traditional economic system become increasingly incompatible, resulting in economic chaos. Therefore, the government has to return to the traditional method to tighten its control over the economy. Thus, "chaos leads to a retrenchment program," and "retrenchment leads to a bust." Then the cycle begins again. This cycle has caused fluctuations in the growth rate and may become an impediment to China's sustained economic growth.

Second, corruption has become an increasingly serious problem. The dual price system creates a gap between planned prices and market prices and has led to rent seeking. The nonstate and the autonomous state enterprises certainly have an incentive to use bribes and other measures to seek rents from the state allocation agencies. Thus, the corruption of government officials has grown rampant. It has also caused widespread public resentment and has become a source of social instability.

Third, despite the great success of China's overall economic reforms, the performance of state-owned enterprises has worsened. State-owned

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enterprises have become the biggest drag on the economy and drain on the government treasury. According to the authors, the problems of state-owned enterprises are rooted in the traditional economic system and the lack of well-defined property rights. Nominally, state-owned enterprises belong to all the people, but they cannot be operated by all the people. In the reform process, more autonomy for state enterprises often created abundant opportunities for the managers and workers to steal state profits and property. To reform the state enterprises, it is essential to clarify property rights—a task that remains the most difficult part of China's reform process.

The authors believe that the above problems result from the fact that reforms of the overall market environment lag behind reforms of micromanagement institutions and resource-allocation mechanisms. To solve the problems, China must reform the macro-policy environment, complete the transformation of the old development strategy, and establish a competitive market economy.

In Chapter 9, the authors summarize the lessons from China's reforms. A key lesson is that China's economic reforms have been a gradual process of experimentation, which started with improving micromanagement institutions, moved to reforming the planned resource-allocation mechanism, and, finally, changed the overall environment and developed a market economy. This way, China has maintained a balance between speed and stability during the reform process and has avoided political and social turmoil. The majority of workers and farmers have benefited from the reform, and their support of it makes the reform process irreversible. The successful experience of China's reforms provides useful lessons for other reforming economies.

In conclusion, the authors point out that the key to sustained growth in China is further market liberalization. As long as China can carry out the reforms that help it exploit its comparative advantages, the country will continue to prosper.

This book provides a very impressive and comprehensive overview of China's economic reforms and development. At certain points, however, the reader wishes for a more detailed and cohesive treatment of key arguments. For example, the relationship between the development strategy and the choice of economic institutions, which is at the center of the book's arguments, needs further analysis and illustration. Despite that, the book could serve as a useful textbook for students or as a reference for scholars of the Chinese economy. It also could be of interest to general readers interested in China's development.

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After 1989: Morals, Revolution and Civil Society
Ralf Dahrendorf
New York: St. Martin's Press, 1997, 179 pp.

The collapse of the Soviet Union continues to fascinate scholars and political observers. One of the latest in a long series of post-1989 musings

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is *After 1989: Morals, Revolution and Civil Society*, a collection of papers by Ralf Dahrendorf. Well-known among theorists of democracy, Dahrendorf has been active in the academic as well as the political world: warden of St. Antony's College at Oxford for the past decade and director of the London School of Economics for the decade prior to that, he had also been a European Commissioner during the early 1970s. With such a background, he may well be expected to write what he describes as "neither a work of scholarship nor a popular tract, but both." Predictably, however, such hybrids are more likely to be neither. But that does not mean that *After 1989* does not offer some interesting insights.

The essays in this book cover a span of six years, from 1990 until 1996. Mostly ceremonial speeches, they show a genuine concern with many of the great questions of political science: What is the purpose of revolution? What is the relationship between economic and political institutions? What is the meaning of civil society? What are some of the principal challenges of modernity? How do we build meaning into our lives? That Dahrendorf asks those questions in the context of the changes that took place in the former Soviet Bloc indicates that he recognizes the crucial importance of those changes, their rich potential to teach us profound lessons about the nature of Western liberalism, and its ability to usher humanity into the 21st century. Whether those lessons can be learned, however, depends on two issues: first, whether we ask the right questions; and second, whether we have the facts straight. While Dahrendorf falls somewhat short on both, he does touch on several important themes.

In his first essay, he defines the 1989 revolution as a quest for democracy. He notes, however, that the term is ambiguous, for it refers to both the constitutional context (formal democracy) and "equality" (substantive democracy or equality of outcome; in his words, democracy "become real"). His conclusion follows, not unexpectedly: "The revolution of 1989, like other revolutions before it, was bound to disappoint those who entered it with extravagant hopes for a new world of unconstrained discourse, equality and fundamental democracy" (p. 12).

To begin with, it would be impossible for that (or any other) revolution to create all the conditions for democracy in such a short time. Thus Dahrendorf's pessimism is rather surprising. Writing less than a year after the fall of the Berlin Wall, he declares that the revolution of 1989 "has created conditions which militate against successful political reform, effective economic reform and the firm establishment of civil societies" (p. 13). In reality, the evolution of political and economic institutions throughout the former Soviet Bloc, while very uneven, has been proceeding in a roughly linear progression in the direction of greater liberalization. This is not to say that prosperity is within reach for most of the population, by any means. The destruction of communism will take many decades to undo. But even in Central Asia there has been progress in privatization and greater political participation. Perhaps by setting the goal of the revolution too high, Dahrendorf is bound to expect it to be unreachable.

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A number of factual misconceptions as well prevent him from understanding the complexity of the 1989 revolution. He writes, for example, that "in East and Southeast Central Europe the collapse of the nomenklatura has left behind . . . an administrative vacuum," yet one of the paradoxes of the revolution was precisely that the *nomenklatura* managed to change political colors with enviable, opportunistic talent. Andrew Nagorski documented that very well in his 1994 book *The Birth of Freedom*. Not that there are no new faces among the post-revolutionary elites, notably Václav Havel, Lech Walesa, Viktor Orban, and Emil Constantinescu. But especially in the former Soviet republics, the emerging leaders, such as Boris Yeltsin and Edward Schevarnadze, to name but the most liberal, were surely members of the old guard.

The lack of radical change in the socio-political structure of these nations was not without some advantages. In the first place, the old technocratic elite (admittedly undertrained and generally mistrained, by Western standards) had learned some important skills of organization and adaptation. What is more, fratricide was thereby avoided in the already tortured, poverty-stricken wasteland of postcommunist Eastern Europe. But the price was high, as Alexander Solzhenitsyn anticipated in *The Gulag Archipelago*, where he warned against the temptation to forget the crimes of communism lest nations be haunted by a guilt-ridden past. Many of the *nouveaux riches* are seen as ruthless and soulless; they are envied, sometimes even detested, at the very least not trusted. The vacuum that was left was not as Dahrendorf indicates, "administrative" but moral.

Not that Dahrendorf is oblivious to the enormous thirst for moral renaissance that both preceded and followed the 1989 revolution. Quite the contrary. He purports to seek "moral objectives" that humanity should strive for, but defines them mainly in negative terms: they are what liberty and capitalism are not. In brief, they are "citizenship and civil society," which go "one step further than elections and markets." Invoking political theorist Giovanna Zincone, Dahrendorf says that the path from "subject" to "citizen" is "the path to freedom." He defines "citizenship" vaguely as "a set of entitlements common to all members of society." Yet he seems to want it both ways, for he also insists that "no one should be made to take a particular choice or even be guided towards it; freedom includes the options not to choose at all or to choose wrongly." But if "obligations" are to mean anything, surely they must involve an element of necessity, or else there is nothing obligatory about them.

In the final analysis, it appears that Dahrendorf is not particularly comfortable with freedom even as he appears to embrace it. On the one hand, he seems to favor liberalism in both a political and economic sense: "The creative chaos of associations coalesces as if guided by an invisible hand into the setting in which the greatest number find the greatest life chances. In economic terms, the market describes that setting; in political terms, it is the public" (p. 78). On the other hand, however, he deplores

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"the greedy individualism" he feels the market approach necessarily presupposes.

Dahrendorf comes close to endorsing capitalism. He applauds the Open Society as "the world of democracy and the market economy, [which are the two components of] the constitution of liberty" (p. 46). He praises them both as "eminently reasonable ways of organizing our affairs." But they are not enough: their main drawback is that "they do not offer people a home" (p. 57).

That home is civil society and its "creative chaos," which somehow protects us against the inconveniences of the state of nature as well as "against those arising from monopolistic claims by self-appointed minorities and indeed majorities" (p. 56). Just how civil society does that is not clear. Dahrendorf seems to secure the answer by definition, for he says, "Civil society is a society of citizens who have rights and accept obligations, and who behave in a civil and civilized manner towards each other" (p. 78). In other words: utopia. Predictably, Dahrendorf does not come much closer than his countless predecessors to telling us just how to achieve it.

His disappointment with the post-1989 conditions in the former Soviet Bloc are probably colored by his high expectations of what constitutes an ideal civil society. He states, for example, that "the instruments of government are crumbling in the tender hands of dissidents-turned-rulers" (p. 97); yet this surely is too strong, for no outright "crumbling" has happened in any of those countries. (Belarus and Turkmenistan never quite emerged from authoritarianism.) Similarly, the claim that "the new economism of capitalists is no less illiberal than the old one of Marxists" (p. 99) is far too radical; it ignores the many changes that have taken place even in the slow-moving nations of Central Asia. The charge that former Czech Prime Minister Václav Klaus is guilty of "democratic authoritarianism," and the claim that Klaus actually "opposes civil society" even as he "strengthens central government" (p. 97), would be considered even by Klaus' Czech foes as hyperbolic.

It is curious to see a book such as this, appearing eight years after one of the most extraordinary events of the 20th century, proclaim categorically that since all revolutions must be prevented because "all revolutions fail," the 1989 revolution too, by implication, should not have taken place. Dahrendorf's conclusion that "the first requirement of the constitution of liberty [is] to make sure that [revolutions] need not happen" is thus nothing short of mystifying. While that statement is undoubtedly true in some vague conservative prudential framework, Dahrendorf apparently fails to recognize that of all revolutions, the one that ended communism not only had to happen but continues to be happening each day, as its people begin the arduous journey toward a civil society. They barely know how to define that concept; but they have faith that some day, perhaps even in their lifetime, they will enjoy its fruits. Their

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patience and courage are surely an example to us all, and the tragedy of what they rejected a constant reminder that freedom is far easier to lose than to build.

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Classical Liberalism and International Economic Order: Studies in Theory and Intellectual History
Razeen Sally
London: Routledge, 1998, 226 pp.

In today's debate about free trade and the global economy, who are the rightful heirs of Adam Smith and the classical liberal tradition? Are they the builders of a "new global architecture" who seek free trade and financial stability through multinational institutions? Or are they the neoclassical economists with their abstract models of perfect markets, perfect knowledge, and optimal equilibrium? The answer is neither, according to Razeen Sally, a professor of international political economy at the London School of Economics, in his provocative new book.

This book is rich in the history of ideas but also in spirited argument. Its ambition is to revive classical liberalism as a way of thinking about the global economy and to apply its wisdom to the current policy debate. Sally deftly defines the system of political economy first expounded by the Scotsmen Adam Smith and David Hume—a system built on individual liberty, spontaneous order, and the evolution of law and other institutions to provide the "rules of the game" for mutually beneficial commerce. He surveys the intellectual refinement of classical liberalism in the 20th century, from Frank Knight, founder of the Chicago School, through Jacob Viner, Wilhelm Röpke, and Jan Tumlir, with a bow to F.A. Hayek along the way.

The author draws a sharp distinction between classical liberalism and its modern intellectual step-siblings—neoclassical economics and neoliberal institutionalism—that dominate today's argument for trade liberalization. The trouble with neoclassical economists, according to Sally, is their reliance on abstract economic models that ignore the political, legal, and social context in which markets function. Their models assume perfect markets in which rational actors maximize their utility under budget constraints to reach equilibrium, while the classical liberal approach relies on empirical observation of how markets really work. Neoliberal institutionalists are equally mistaken in their reliance on international organizations, negotiations, and intergovernmental policy coordination to advance liberalization. Ignoring the classical liberal insight of spontaneous market order, they believe that only vigorous intervention on a multinational level can save the global economy from disorder and beggar-thy-neighbor trade wars.

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A number of prescriptions and warnings for international economic policy flow from classical liberal analysis. First, the death of the nation state is greatly exaggerated. Sovereign nations remain the principal source of laws that set the rules for international commerce. International arrangements such as the World Trade Organization more accurately reflect the will of their member states than constrain their actions. The key to a sound international economic order is sound domestic policies of stable money, free markets, and protected rights to property and contract. As Röpke argued, a liberal international economic order, "like charity, should begin at home."

By the same logic, interventionist policies at home breed interventionist policies abroad. Tumlir argued that the breakdown of international economic order between the two world wars was caused primarily by the rise of statism within nations, not by a lack of cooperation among them. This growing intervention in domestic economic affairs put pressure on governments to insulate their economies from outside competition. Thus, according to Tumlir, "protectionism is the inherent logic of the redistributive state working itself out externally."

Second, a classical liberal approach warns against vesting power in multinational organizations, even when their stated mission is market liberalization. This "liberalism from above," as Sally describes it, contains inherent dangers. It leads to "complex mechanisms of intergovernmental cooperation, with their tendency to degenerate into political cartels that encourage discretionary power and bureaucratic expansion while avoiding both domestic political accountability and market disciplines." According to Sally, "Neoliberal institutionalist enthusiasts of intergovernmental cooperation almost wholly ignore such features of 'international government failure.' "

A more enduring and principled approach to liberalization would be what Sally alternatively calls "liberalism from below." This approach relies on nation states as the principal actors in setting international economic policy. Those policies are determined through trial and error, in response to internal political pressures and institutional competition with other states. As individual nations discover the benefits of unilateral liberalization, other nations face a kind of market pressure to adopt more liberal policies to keep up with their more prosperous free-trading neighbors. In this way, competition in an unrestrained global policy market leads to better policies, just as competition spurs better production methods in a free domestic economy.

Third, classical liberal thought weighs heavily in favor of unilateral free trade. Even if free trade is not always the optimal economic policy according to neoclassical trade theory, it is virtually always the best policy in the broader context of political economy. As Viner argued, protectionism—no matter what its underlying theoretical justification—often invites retaliation by other nations. Once trade barriers are imposed, they create a political constituency that makes them difficult to remove

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even after the original justification has long passed. Policymakers simply lack the information necessary to intervene in an intelligent and beneficial manner, even if a policy may exist in theory that would be superior to free trade.

Ultimately, the classical liberal approach puts the argument for free trade on more solid ground. "Modern advocates of protection," Sally writes, "have not learnt the lesson taught by the classical economists: the presumption against protectionism, while having a (hardly cut-and-dried) theoretical rationale, relies heavily on the empirical observation that government intervention is usually short-sighted, with an unavoidably inadequate understanding of the coherence of economic phenomena. Usually, this leads to results more harmful than those that follow from nonintervention. As the more policy-attuned neoclassical trade economists would put it, the costs of government failure usually outweigh the costs of market failure in international economic policy."

Classical Liberalism and International Economic Order buries the myth that free trade is a utopian dream incompatible with the realities of this world. As Sally demonstrates in this important book, in a world of imperfect people and imperfect governments, free trade is the most realistic policy of all.

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The Fluttering Veil: Essays on Monetary Disequilibrium
Leland B. Yeager; edited and with an introduction by George Selgin
Indianapolis: Liberty Fund, 1997, 441 pp.

Economists of all persuasions should welcome this collection of Leland Yeager's critical work on monetary disequilibrium. Yeager is a serious thinker who does not burden his readers with trivia. His work emphasizes fundamental issues for which he has constructive and, at times, unique contributions. These essays reflect the path of Yeager's thinking on monetary affairs over several decades, and thereby highlight major theoretical and policy problems that have beset the economics profession and the U.S. economy over this time span.

The major sections of the book, after the Editor's Introduction, are: (I) Monetary Disequilibrium and Its Consequences (Chapters 1–3); (II) Monetary Misconceptions (Chapters 4–8); (III) Keynesianism and Other Diversions (Chapters 9–12); and (IV) Avoiding Monetary Disequilibrium (Chapters 13–18). Virtually every selection in the book is worth reading for its fundamental insights on the nature of money, how money is supplied, and how people behave when they have money in their hands or wish that they did.

Three or four of the selections are major advances in the economic profession's valid comprehension of monetary theory and policy. Those pieces are so fundamental that no practicing economist can afford to be

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unfamiliar with them. At least three, "Essential Properties of the Medium of Exchange" (Chapter 4, 1968), "The Significance of Monetary Disequilibrium" (Chapter 10, 1986), and "A Laissez-Faire Approach to Monetary Stability" (Chapter 15, 1983), rank as contributions of the same importance as W.H. Hutt's "Yield on Money Held," Don Patinkin's "Price Flexibility and Full Employment," and Milton Friedman's "Optimum Quantity of Money," to mention just a few.

The first selection, "A Cash Balance Interpretation of Depression," published in 1956 when the Great Depression was still in recent memory, emphasizes the analytical and policy simplicity of concentrating attention on the stock of money when treating economic depression. Yeager notes here that analysts may regard a depression either as an excess demand for money or as an excess supply of goods—the Walrasian identity. Policy can do nothing about the excess supply of goods, which is only "excess" at the prevailing price level, but it can readily supply the deficient money at very little cost. Otherwise, wages and prices must suffer an agonizing adjustment downward to reach some subterranean price level.

That article reveals the beginnings of Yeager's absorbing interest in adjustment from an economic disequilibrium. In "Essential Properties of the Medium of Exchange," Yeager took issue, as did some other economists including this one, with the notion that money was just one asset in a liquidity "spectrum," different in degree but not fundamentally different in kind from other financial assets. Those other financial assets were obviously stores of value similar to money and could be held as such. They therefore could substitute for each other and for money, and all that remained was a means to measure their elasticities of substitution with money. I remember having similar thoughts in the mid-1950s, and trying to develop a meaningful and measurable hypothesis to test them. I thought then that some measure of the velocity of money would reveal the elasticity I was looking for.

Yeager, however, took the analysis along a different line. Instead of working on the question from the demand side—that is, how people demand money relative to, say, Savings & Loans shares, wheat, or government bonds—he approached the issue from the standpoint of market adjustments in the various "near" moneys and money itself. Everyone knew that money was special in that it was the medium of exchange. But Yeager was the first to point out that *only* money was the medium of exchange. It is always the "other" item in all transactions. Everything except money clears its demand with its supply in a market, but money being the medium for all those other market clearings is bereft of a market for itself. Too bad for money, because that characteristic means that money can only reach its equilibrium through its obverse relationship in all other markets. Its "price," perforce, is the reciprocal of the average of all other prices. An economist's mind can envision "all other markets" easily enough, but all other markets do not reach their respective equilibria by someone thinking through their ultimate positions. As Yeager

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emphasizes repeatedly in this work and throughout the book, the process of an all-markets' adjustment is often slow, painful, roundabout, resisted, and institutionally hampered. No other commodity or financial asset has this problem. Even the nearest of "near" moneys clears in a single market. For example, if an excess supply of S&L shares tried to appear, falling prices for the shares and rising interest rates would prevent the "supply" from ever appearing. The shares cause no pervasive disruption in other markets. Money, however, is always acceptable. People want it, Yeager observes, because they can so readily "unwant" it (p. 93).

In the selections, "What Are Banks?," "Individual and Overall Viewpoints in Monetary Theory," "Money and Credit Confused: An Appraisal of Economic Doctrine," and "The Significance of Monetary Disequilibrium," Yeager treats in detail several conceptual differences and distinctions of which an observer must be conscious when dealing with monetary institutions and the economy's adjustment to disequilibrium conditions. First is the difference between adjustment in "the" money market and adjustment in the market for any other good or service, emphasized so painstakingly in "Essential Properties."

Another major distinction is between banks as creators of money and any other businesses, including nonbank financial intermediaries, that do not create money. Being creators of money, banking operations are a part of the cumbersome adjustment process previously described.

Likewise the central bank is different from the commercial banking system. Both create money, Yeager notes, but the central bank does so as part of a deliberate policy without reference to any profit-and-loss constraints. Banks, however, create money (demand deposits) indirectly, as an unintentional byproduct of their lending operations. Individual bankers do not know they are creating money, and often deny vehemently that they do.[1] "Since [the creation of] money is a by-product of the banking system's nominal expansion [of credit]," Yeager properly reasons, "[banks'] costs and revenues are not those of producing nominal money" (p. 120). Therefore, bank-created money, which is willy-nilly a medium of exchange, is outside any cost-revenue-equilibrating market process.

Yeager also stresses the difference between rational behavior for an individual and what would be rational behavior for society as a whole. Since "society" cannot think or behave apart from the thoughts and actions of individuals who make up society, collective "rationality" is not a basis for meaningful action. Therefore, a disequilibrium condition does not necessarily yield to a simple rational solution without much travail and gnashing of teeth. Yeager sharply criticizes the attempt by the rational expectations school to define away any disequilibrium in the face of clear-cut factual evidence that economic depressions and inflations are indisputable evidence of the same (p. 225).

[1]For more on this subject, see Timberlake (1988).

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Given Yeager's analyses of money's properties, the unreliability of institutions that create and monitor money, and the difficulties of monetary adjustment in the absence of a bounded money market, what could be the solution?[2] Yeager pungently notes that the present system is "preposterous," as indeed it is. Here we have, or at least espouse, a free-market system for all goods and services that works demonstrably better than any alternative order. It not only produces the maximum quality and quantity of goods and services that everyone wants. It also encourages cultural values, arts, science, conservation of natural resources, and morality. Yet, we continue to tolerate uncritically a monetary system that has the flexibility and adaptability of glass, one for which the supply of the particular unit is only remotely related to the demand for it, and one that cannot clear its own market without untold and undesirable ramifications to the rest of the economy. How can the rules and institutions that govern money be amended to encourage a smooth-working market-driven medium of exchange?

Yeager does not mention the fact—probably because he thinks it is too obvious—that the circumstances, times, and places that witnessed the appearance of moneys have been legion, and never under any sanction or initiation from the state. Yet, in every country in the world today, the state jealously controls monetary systems with the strictest authority. Could the ubiquitous assumption of state control perhaps be the problem?

Yeager agrees that the state and its central banks are a major problem. However, even with angels guiding central banking policies, the absence of a single market in which money can clear properly is still a major difficulty. In his (and Robert Greenfield's) "A Laissez-Faire Approach to Monetary Stability," Yeager comes to grips with the intrusion of the state into day-to-day monetary affairs, and with the peculiarity of the market for money.

The crucial element of disequilibrium in present-day monetary systems, besides what central banks foment, Yeager and Greenfield contend, is the identity of the unit-of-account and the medium-of-exchange. This identity in real life is the "scruffy" one-dollar bill. No other unit of measure is so combined and confused with its agent of measure.

The U.S. Constitution provides for Congress "To coin Money, regulate the value thereof, . . . and fix the standard of weights and measures" [Art. 1, Sec. 8]. Section 10 then declares that, "No State shall . . . coin Money; emit Bills of Credit; [or] make any Thing but gold and silver Coin a Tender in Payment of Debts." Congress has properly fixed the standard of weights and measures, as it was so authorized, without any attempt to manufacture yardsticks and balance weights. Its parallel function with

[2]Rigorously defined, "the" money market is the Yeager concept in which the quantity of money desired by everyone tends to an equilibrium with the quantity in existence. The popular concept of "money market," in which short-term interest-bearing securities are demanded and supplied at different prices and interest rates, is simply an enduring misnomer.

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respect to money, however, has been pervasively and grossly abused. Over the decades since the writing of the Constitution, what was supposed to be a nonpolitical commodity-anchored unit of account has become a government monopoly of legal tender fiat paper money. Besides the loss of the gold mooring through deceitful political and judicial machinations, the unit of account, originally specified in gold (and silver) but now simply fiat paper, has become identical to the medium of exchange both in concept and in practice.

Yeager would reverse that unconstitutional distortion of the monetary system. He and Greenfield label the system they have devised the BFH system.[3] To understand the workings of BFH, they suggest that one should begin by putting aside any preconceptions about money and simply consider the operation of a gold standard unencumbered with a central bank or any other government trappings. Let Congress prescribe a unit of account labeled, say, a Unit. For the moment let the Unit be a weight (ounce) of gold. Unlike the original U.S. gold Eagle, the gold Unit is not legal tender.

Indeed, in the BFH system, legal tender does not exist, and why should it? Why should the state force us to accept its particular money any more than it forces us to accept a particular brand of toothpaste or a particular brand of yardstick—unless, of course, the state senses how flawed its money actually is? Neither does the state in the BFH system coin money, and it regulates money's value only in specifying the weight of gold of certain limited denominations. If one ounce is a Unit, half an ounce would be a Half-Unit, and so on. All money is coined by private firms. These firms and other private firms, such as banks and mutual funds, issue media of exchange that satisfy people's common requirements for transacting business and making other exchanges.

Given that the Unit (of account) is legally specified as one ounce of gold, any privately produced medium of exchange (Medex) would have to be of a value equal to the gold Unit. No government agency or central bank would oversee or "guard" this relationship, any more than a fox "guards" a chicken house. Government's only monetary function would be to enforce contracts entered into by private firms and households. Competition among Medex producers would keep any advertised Medex value-constant in terms of gold. As Yeager and Greenfield remark, like a dash of cold water: "Money would not exist" (p. 368). Their plan is a barter system, but a very refined form of barter. Their Unit is a property that exchanges for other property by means of competitively produced Medex.

I have used gold to describe the BFH system because explaining it with a single familiar commodity is easier. However, instead of gold, Greenfield and Yeager use a broad-based commodity Unit. Their Unit

[3]The term "BFH" refers to three economists, the late Fischer Black, Eugene Fama, and Robert Hall, who have proposed monetary systems with some of the elements that Yeager and Greenfield use.

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is defined as the total market value of a bundle of easily recognized and commonly used commodities that would accurately reflect the market value of "all commodities." However, no agency would store those commodities or redeem the Unit by direct convertibility into the designated bundle. "Instead, its value is fixed by definition" (p. 368). Space does not permit a detailed description of how private producers of Medex would maintain its value in terms of the Unit, but the gold analogy suggests the stabilizing mechanism.

In the final chapters of *The Fluttering Veil*, Yeager acknowledges the practical political difficulty of revising the monetary system along the lines he and Greenfield so painstakingly sketch. Even though the present system is "preposterous," he is certainly correct that any reform in the direction of laissez-faire production of money is almost impossible. Since the BFH system would revoke the federal government's lucrative seigniorage from the printing of legal tender paper money, its fate is sealed for perhaps the next century, or for whatever time it takes for civilization "as we know it" to reinstitute constitutional bounds on Leviathan.

Nevertheless, Yeager's insightful and cogent analysis is there for the ages. Its truths cannot be politicized. And though the momentum of contemporary institutions will doubtless preclude adoption of the BFH system, at least we can say, "Thank you Leland Yeager. Perhaps events in the 22nd century will vindicate your labor."

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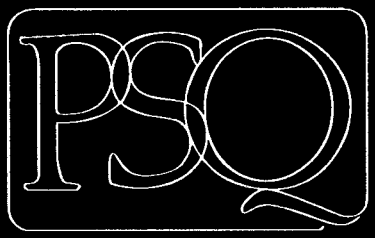

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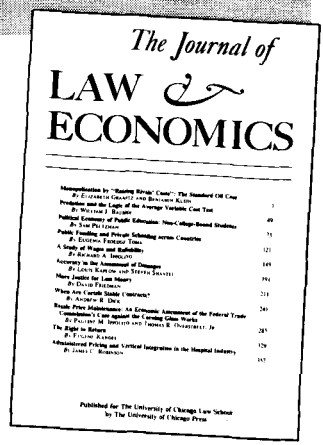

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—Albert Einstein

The World As I See It
(London: John Lane, 1935), 79.

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